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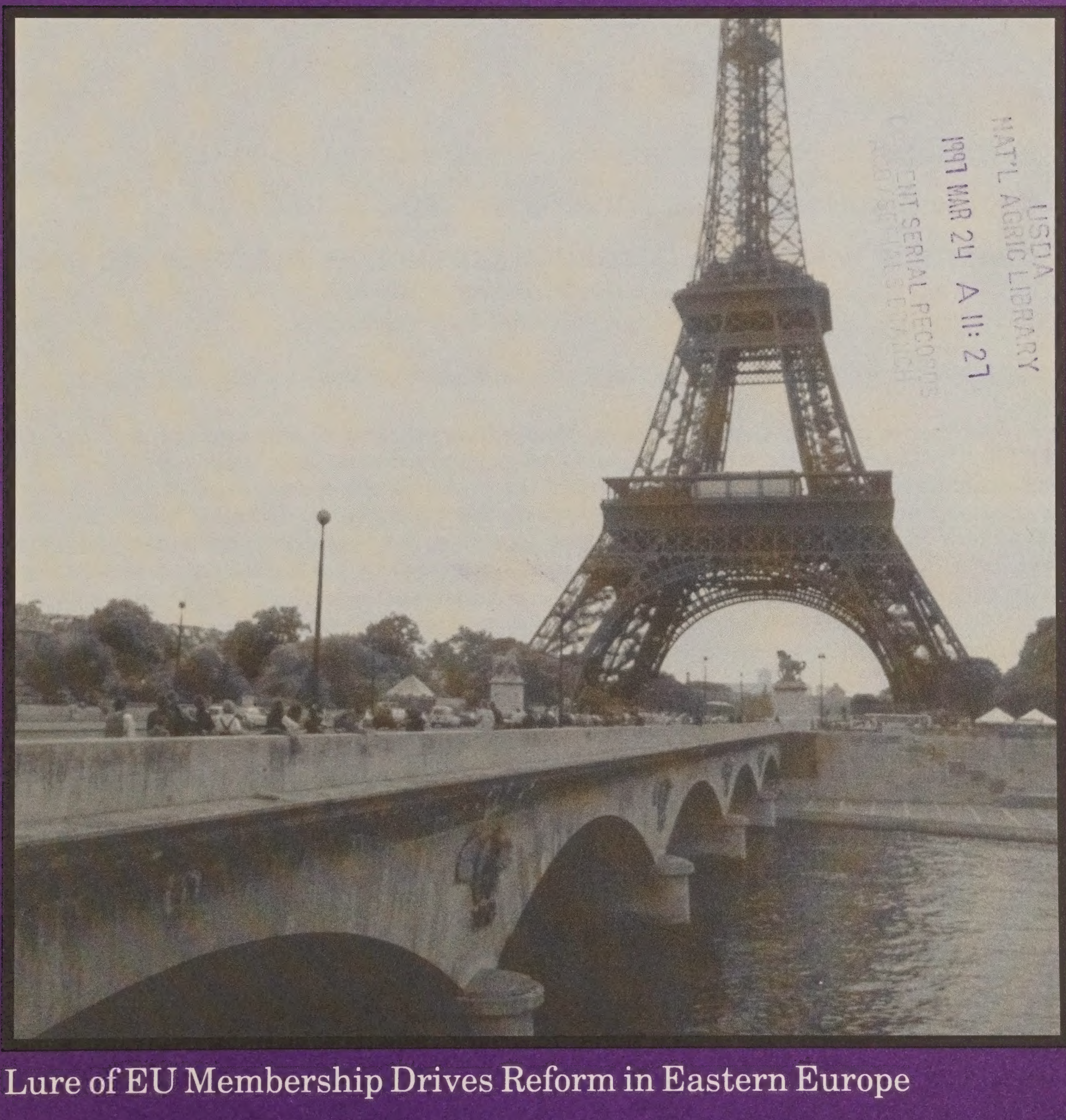

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Foreword

The impending eastern enlargement of the European Union could add as many as 100 million new consumers to the EU's single market and double the number of farmers, having significant effects on global and U.S. agricultural trade.

On October 22 and 23, 1996, the Europe Team of USDA's Economic Research Service (ERS) hosted a conference on the future of European agriculture. "EU Eastern Enlargement: Feast or Fizzle for U.S. Agriculture?" brought together policymakers, analysts, and representatives of agribusiness to discuss an array of issues pertaining to the next round of enlargement. The 2-day forum presented several perspectives and highlighted the magnitude and complexity of the changes the countries of Central & Eastern Europe (CEE) are undergoing.

The countries of Central & Eastern Europe achieved remarkable progress in their transition to market-oriented economies, with significant financial and technical help from the West. Unemployment is declining, incomes are increasing, and the standard of living throughout the region is improving. Yet much remains to be done before the CEE countries can integrate fully with western economies. Privatization and land restitution are moving slowly, farm productivity is lagging, and further reforms are needed in the banking and marketing sectors, to name just a few challenges.

This report is a collection of articles expanding on themes discussed at the October conference. Several boxes summarizing conference panels are interspersed throughout the report, complementing the appropriate articles, and a list of conference panelists can be found in the Acknowledgments section at the front of the publication.

Acknowledgments

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Weights and Measures

The metric system of weights and measures is used in this report. The following are conversions to the U.S. system of weights and measures.

1 hectare (ha) = 2.47109 acres

1 kilogram (kg) = 2.204622 pounds

1 metric ton (mt) = 2,204.622 pounds

1 metric ton = 1.102311 short tons

1 metric ton of wheat = 36.7437 bushels

1 metric ton of corn = 39.368 bushels

1 metric ton of barley = 45.9296 bushels

Timeline of EU-CEE Economic Relations

1989	Nov	Berlin Wall falls, presaging the collapse of communism throughout Central & Eastern Europe; new governments begin transition to market-oriented economic systems
1990		PHARE Program, originally designed to assist Poland and Hungary, launched by the European Union
1991	Dec	First Europe Agreements signed with Poland, Hungary, and Czechoslovakia. Following 1993 "Velvet Divorce", separate agreements are signed with the Czech Republic and Slovakia
1992		
1993	Feb	Romania signs Europe Agreement
	Mar	Bulgaria signs Europe Agreement
	June	Copenhagen Summit launches pre-accession strategy for Central & Eastern Europe
1994	Mar	Hungary submits application for EU membership
	Apr	Poland submits application for EU membership
	Dec	Essen Summit adopts pre-accession package to build on the Europe Agreements
1995	May	White Paper of CEE preparation for integration into the EU's Single Market presented by the Commission
	June	Romania, Slovakia submit applications for EU membership
	June	Estonia, Latvia, Lithuania sign Europe Agreements
	Oct	Latvia submits application for EU membership
	Nov	Estonia submits application for EU membership
	Nov	Commission issues Agricultral Strategy Paper and country reports on the agricultural situation and prospects in Central & Eastern Europe
	Dec	Bulgaria, Lithuania submit applications for EU membership
1996	January	Czech Republic submits application for EU membership
	June	Intergovernmental Conference (IGC) on institutional changes and preparations for enlargement begins
	June	Slovenia signs Europe Agreement
1997		(Intergovernmental Conference Ends)
		(Accession negotiations begin 6 months after conclusion of IGC)

Summary

EU's Eastern Enlargement Holds Promise and Uncertainty for U.S. Agricultural Exports

The prospective eastern enlargement of the European Union (EU) could add as many as 100 million new consumers to the EU's single market and double the number of farmers, having profound effects on global and U.S. agricultural trade. USDA analysis indicates that enlargement will increase agricultural output in Central & Eastern Europe (CEE), particularly in the livestock sector, creating increased demand for feedstuffs and opportunities for additional U.S. corn and oilseed exports. Central & Eastern Europe will continue to be an important region for U.S. agriculture, as it is an expanding market for U.S. farm exports and a strong magnet for U.S. investment.

Ten CEE countries, including the Baltic states, have applied for membership in the European Union and have signed Association Agreements with the EU.[1] The Agreements provide a framework for preparing the CEEs for eventual membership, but have had mixed success in expanding CEE-EU trade because of EU protectionism. Since 1992, the EU has had a growing agricultural trade surplus with the CEEs.

The CEE countries will benefit from EU membership through unrestricted access to EU markets and higher producer prices for CEE farmers. However, membership will not be without cost. Higher expenditures will be required to support CEE agriculture at current EU prices and completely open borders will increase competition with Western Europe's agro-food sector.

Considerable restructuring of the CEE agricultural sector is required for successful integration into the EU. The challenges remaining for the CEEs include improvement of farm productivity, the completion of privatization of state farms and agro-industry, the simplification of intervention practices, training in agribusiness and quality control, and programs to encourage rural development and structural adjustment.

The EU has taken a multi-pronged approach in its preparations for enlargement. It has funded an extensive program of technical assistance for the CEE region, designing projects to improve agricultural structures and market mechanisms, food production, processing and distribution, and infrastructure. The 1996 EU Intergovernmental Conference is addressing institutional preparations for enlargement and the question of reinforcing political union.

The CEE countries will be required to adopt all EU legislation immediately upon becoming EU members. This involves setting up structures necessary to make the legislation effective. In the agricultural sector, these measures will affect a wide range of activities in the production and processing industries.

The European Commission has examined different enlargement scenarios to measure the economic implications, including the implications for the CEE and EU farm sectors. The favored approach would continue the reform efforts begun in 1992 in an effort to improve EU agricultural competitiveness.

USDA also conducted preliminary analysis on the impact of accession, using two scenarios: one where the current Common Agricultural Policy (CAP) applies to CEE, and another where farmers in the enlarged EU-19 (including the Czech Republic, Hungary, Poland, and Slovakia) face world prices. Large increases in CEE production could lead to lower world prices, dampening CEE production gains slightly. The results reveal that the agricultural economies of both the EU-15 and the CEE countries are likely to experience major adjustments. The EU-19 will become an even larger wheat exporter, while potentially importing more corn. Meat production will shift somewhat from the EU-15 to CEE. The EU-19 will continue to have some exportable surpluses of pork and poultry.

Prospects for U.S. agricultural exports to the region are favorable in the near term, particularly for high-value products. Exports of bulk commodities, particularly grains, have declined since 1990 and fluctuate from year to year. Opportunities for increased U.S. trade with the CEE countries will likely be affected by government intervention, increased protection, and stiff competition from the EU. High tariffs, adopted by CEEs in the Uruguay Round Agreements, will also limit market access. As EU members, the CEE countries will adopt EU veterinary, sanitary, and phytosanitary standards. Whatever restrictions on trade exist between the current EU-15 and its trading partners will then also apply to the new member countries.

EU enlargement could lead to greater protection against goods from the United States and other non-EU countries. Under current CAP policies, surpluses of many agricultural products would likely develop in the region. The surpluses would be harmful to U.S. agricultural exports to CEE, and could also mean increased competition for U.S. exports in third-country markets. However, rising income growth resulting from EU membership should increase overall demand for agricultural products, and U.S. exports could rise as total exports to the region expand. U.S. exports of oilseeds, oilseed products, and some feeds may benefit as the livestock sector expands. An expanding and modernizing farm sector may also raise demand for U.S. agricultural inputs.

As demand expands in the CEE countries, U.S. businesses may find opportunities for investing in upstream sectors such as fertilizers and agricultural machinery, and in downstream sectors such as food processing and distribution. However, investment opportunities may be tempered by political and economic instability in the region and competition from Western Europe.

[1] The ten countries are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

Introduction

Why Central & Eastern Europe Matters To U.S. Agriculture

The United States has had a keen interest in the countries of Central & Eastern Europe from the very beginning of the transition process in 1989. At the most fundamental level, the United States has a stake in fostering political stability and promoting democracy in the region. Stability and democracy can survive only if underpinned by vibrant, healthy economies, which in turn require healthy agricultural sectors and open markets with free and fair trade. Many countries of Central & Eastern Europe have made stunning progress in their transition to market economies, and trade with the West has boomed since 1989. U.S. agricultural exports to the region are expected to set a new record of roughly $400 million in 1996, making the region one of the fastest growing markets for U.S. farm exports.

Trade statistics illustrate just one aspect of the region's importance. The region also presents U.S. firms with good investment opportunities. The region benefits from a highly educated workforce, close proximity to major markets in the European Union and the former Soviet Union, and rapidly growing economies with rising per capita incomes. Investment and joint venture opportunities are particularly good in the areas of farm inputs, marketing, and food processing. Many U.S. companies have already invested heavily in the region, and most are finding their efforts to be profitable and mutually beneficial. As far as investment is concerned, the region is particularly important at the present time, because it will likely become more difficult for American firms to compete with established EU firms after enlargement.

EU enlargement will inevitably have implications for European agriculture, which is another cause for U.S. interest in the region. The European Union is a global player in agricultural trade. It is one of the world's largest and most competitive agricultural exporters and is a major force in multilateral trade negotiations. Therefore the prospect of adding 100 million new consumers and doubling the number of farmers in the EU is a matter of keen interest to U.S. agriculture, because it is likely to be an impetus to major change.

Any changes to the EU's Common Agricultural Policy will be watched closely from across the Atlantic. The countries of Central & Eastern Europe have huge agricultural sectors, which, despite the advances of recent years, are generally underdeveloped relative to those of the European Union. The application of current CAP mechanisms to Central & Eastern Europe would have a huge impact on the EU's budget. Accession would significantly increase agricultural production in the CEE countries, but would also require the European Union to increase its agricultural spending by billions of dollars per year. It is increasingly likely, therefore, that the next enlargement will precipitate the most sweeping reform in the history of the Common Agricultural Policy. The United States views this prospect positively as an opportunity for the European Union to further liberalize its agricultural policies and build on the accomplishments of the Uruguay Round agreements.

Of course, enlargement will inevitably have a considerable impact on agricultural trade. While the United States supports the enlargement of the European Union, it is also committed to furthering the development of free trade in the global economy. Therefore, the United States contends that any future accession to the EU should be consistent with the Uruguay Round trade agreement and wants to ensure that enlargement is consistent with WTO disciplines and is non-discriminatory toward U.S. or other non-EU exporters. Furthermore, the United States will defend its access to Central & Eastern European markets, which in many cases took years to develop and foster.

And lastly, the United States has an interest in developing and implementing commodity market programs to improve market reporting in the region and to enhance the ability of U.S. and local agencies to put together good analytical programs. Thus, both the participating countries and assisting countries are enriched by their participation in technical assistance programs.

Central & Eastern Europe has been, and will continue to be, an important region for U.S. agriculture. It is an expanding market for U.S. farm exports, a strong magnet for U.S. investment, and its integration into the European Union will have profound and far-reaching effects on agricultural trade and the world trading system.

Central & Eastern Europe Tackles Challenge of EU Integration

Considerable restructuring of Central & Eastern European (CEE) agricultural sectors is required for successful integration into the EU. CEE countries will benefit from EU membership through unrestricted access to EU markets, and CEE farmers will enjoy higher prices. However, open borders will increase competition with Western Europe's agro-food sector.

As they approach the 21st century, the countries of Central & Eastern Europe (CEEs) anticipate eventual membership in the European Union.[1] Ten of these countries have signed Association Agreements with the EU, and the four "Visegrad" countries (Czech Republic, Hungary, Poland, and Slovakia) anticipate joining within the next 10 years. CEE farmers anticipate benefits from EU integration mainly in the form of higher prices. Everyone involved in CEE agriculture, including producers, agribusiness, and government officials, expect better access to EU markets. The CEEs have had difficulty penetrating the EU market, and with full membership their access to this market would be unrestricted.

However, there are potentially high costs to integration for both the CEEs and the EU. One, which is discussed elsewhere in this report, is the cost to both the CEE and EU budgets of supporting CEE agriculture at current EU prices. But another potential danger is that, with completely open borders between EU and CEE countries, the CEE agro-food sector will find it difficult to compete with Western European firms. This is particularly true of the food processing industry. Some CEE food processors have modernized to the point where their products could meet EU standards. But for most of the CEE food industry, considerable investment is still needed before EU standards can be met. In terms of raw agricultural products, CEE livestock producers in particular will have difficulty competing in an enlarged EU market, as most meat and dairy products produced in the CEEs do not meet EU quality standards.

In many respects the CEEs have made significant progress toward recovery from the recession of the early transition period. Most of the countries have returned to positive GDP growth, and have brought down inflation. Evidence of increased prosperity can be seen in many of the region's larger cities. A growing variety of high quality, domestically produced goods are available in the shops, old buildings are slowly being renovated, and the once-prevalent Russian-made automobiles are gradually being replaced by larger, more expensive cars imported from the West.

But the restructuring of CEE agricultural sectors, essential for successful integration into the EU, remains unfinished. Despite rising output prices, profitability in agriculture continues to be low.[2]

Yields continue to be below the average for the late 1980s and yield volatility has increased, due to reduced use of inputs such as fertilizers and irrigation. There remain unresolved issues surrounding land reform: Some claims from former owners are still tied up in court, and a large number of land owners still do not have permanent title to their land. Privatization of the agro-food industry is still not complete.

Further institutional reform will also be needed before EU integration is feasible. Agencies created in the Visegrad countries (Poland's Agency for Agricultural Markets, for example), Romania, and Bulgaria to administer minimum prices, export subsidies, or other measures often operate in a non-transparent way, leading to questions concerning these countries' compliance with World Trade Organization (WTO) regulations on state trading. State policies in Bulgaria and Romania cause significant distortions in the domestic markets. Procurement of bulk commodities is still mainly in the hands of state-owned companies that use their market power to hold down prices. And these governments continue to exert some degree of control over retail prices through limits on processing margins.

Grain Market in 1996/97 Illustrates Fragility Of Reform

The situation in the current 1996/97 marketing year demonstrates just how fragile is the progress of reform in CEE agriculture. Despite considerable progress in overcoming the institutional rigidities of the Communist period, enough remain to prevent the timely transmission of world prices to domestic producers. When most of the world responded to the high wheat prices of 1995/96 with increased plantings, the signals from the world market did not reach CEE farmers in time. Combined with poor weather conditions and the credit-access problems of farmers, the result was a decline in winter crop plantings. In addition, extraordinarily bad weather during the winter reduced yields. The reduced grain crops triggered a significant rise in real bread prices, and governments yielded to popular pressure to impose restrictions on

[1] For the purposes of this article, CEE refers to the Visegrad group (Czech Republic, Hungary, Poland, Slovak Republic), Albania, Bulgaria, republics of the former Yugoslavia, and Romania.

[2] It is difficult to derive an accurate measure of farm profitability in the CEEs, because there are still insufficient data on production costs. However, studies done for the OECD by CEE economists argue that profitability in agriculture continues to be lower than in other sectors, and that profits have been negative in several of the countries. Losses tend to be greatest in the state-owned enterprises.

Pressure For Change

CONFERENCE BOX #1

Michel Debatisse, World Bank

Michel Debatisse noted that it is difficult to generalize about Central & Eastern Europe because each country has its own unique characteristics and circumstances. There are challenges on both sides of the enlargement equation. The CEEs must learn to compete in a new environment by developing market-oriented economies with transparent, stable, and reliable institutions capable of enforcing the rules in a private market environment. At the same time, the European Union is facing pressures to alter the Common Agricultural Policy to accommodate the needs of its eastern partners and keep budgetary costs from ballooning.

Despite the progress made in CEE agriculture in recent years, there is still a good measure of unfinished business. The privatization of land and agroindustry must continue, and the countries have yet to establish well-functioning land markets. The banking sector is underdeveloped, making it difficult for farmers to obtain credit. Agricultural marketing channels, quality control standards, and the rural infrastructure are substantially below EU levels in most regions. And finally, there remains a high level of market intervention and trade protectionism.

The key pre-accession issues are the improvement of farm productivity through increased mechanization, high-tech inputs, and farm consolidation; the completion of privatization of state farms and agroindustry; simplification of intervention practices; training in agribusiness and quality control; and programs to encourage rural development and structural adjustment. These issues present tremendous investment opportunities for western firms willing to apply their knowledge and expertise to these emerging markets.

exports and in some cases to impose ceiling prices on grains. Also, some governments have imported large quantities of grain to replenish intervention stocks, further diminishing hard currency reserves.

The most important development in the crop sector was the disastrous wheat harvest. This year's harvest fell sharply from the large 35.0 million tons in 1995 to only 26.4 million tons. The decline stems from the lowest yield (3.02 mt/ha) since 1979, and a significant drop in area planted to 8.7 million hectares from a 1990-95 average of 9.6 million. Net CEE exports of 3.1 million tons in 1995/96 are expected to change to net imports in 1996/97 of roughly 1.2 million tons.

The policy response to this grain shortfall reveals a continuing tendency on the part of some CEE institutions to regulate markets. CEE government policies enacted in the name of food security—such as export controls and controls on processing margins—as well as persistent monopolies in the purchasing and processing of grains, prevented the full transmission of prices to producers and contributed to the decline in area in 1996/97.

With low stocks and a reduced crop in 1996, CEE governments responded with even more intrusive regulation of the grain markets. The situation has been most acute in Bulgaria. Since the beginning of the transition, government policies holding producer prices well below world levels have exacerbated the drop in fall plantings. The current crisis began in the summer of 1995, when at least 600,000 tons of wheat were exported as traders took advantage of the growing gap between world and domestic prices. In response, the Bulgarian government has maintained a ban on wheat exports since the fall of 1995. In the fall of 1996, after a particularly disastrous crop and a near doubling of real bread prices, the government began drafting legislation to impose ceiling prices on bread and other basic foods. Meanwhile, necessary imports of wheat for hard currency have added to the current strain on Bulgaria's foreign exchange reserves. Between December 1996 and July 1997, additional wheat imports of up to 400,000 tons may be necessary.

Even some of the Visegrad countries have reacted to the wheat situation with increased regulation of grain markets that is incompatible with their long term goal of joining the EU. The Visegrad countries have all established intervention agencies purportedly modeled after EU institutions. The mission of these agencies is to stabilize domestic markets through the administration of guaranteed minimum prices and export subsidies. Until recently prohibited by the WTO, the agencies also administered variable levies. While these agencies were initially created with a view towards aligning CEE institutions with those of the EU, they tend to exert a strong influence on domestic markets and often do so in a non-transparent way.

For example, in response to the wheat deficit and rising bread prices, the Czech government has given its State Fund for Market Regulation (SFMR) exclusive rights to export or import grain and is considering legislation that will impose a ceiling on producer prices for grains. The Czech Republic, Slovakia, and Romania all imposed a ban on grain exports once the impending shortfall became evident.

The Polish Agency for Agricultural Markets (ARR) has not moved to restrict exports, and in general it does not directly regulate foreign trade. But its activities have a significant impact on the domestic market. In addition to direct intervention purchasing, it provides guaranteed credit to the state grain purchasing companies, many of which cannot otherwise obtain credit. By keeping these companies afloat, the ARR is in effect slowing the privatization of this sector. It is estimated that the ARR is directly or indirectly involved in the purchase of at least half the grain crop. Moreover, the ARR maintains a strategic reserve, the size of which is secret, that can be released on the market any time and influence prices in ways that cannot be anticipated. The ARR uses import purchasing as one means of maintaining its grain intervention stocks.

The above agencies will need to change when these countries join the EU. They will have to cede their authority in setting minimum prices and intervention levels to the European Commission. The analogous transformation of Spain's National Agricultural Products Service with that country's accession resulted in an increased role for private firms in grain marketing and an increase in privately owned storage. There is hope that EU accession would speed up the privatization and streamlining of the downstream sectors in the CEEs. However, the extent that the ARR and similar agencies have interfered with the free formation of prices will make the adjustment more difficult for CEE marketing institutions.

Livestock Recovers, but Quality Lags

The livestock sector was hit hard at the beginning of the transition, as falling consumer demand and rising feed costs led to the massive culling of herds. Declines were steepest in those countries that underwent the most dramatic farm restructuring. With the liquidation of cooperatives in Bulgaria and Romania, animals were turned over *en masse* to private farmers. These farmers often did not have the means to keep the animals, which resulted in indiscriminate slaughter.

Beginning in 1995, livestock inventories in most of the CEEs bottomed out and gradually began to recover. This trend was initially evident among hog and poultry producers, who can react quickly to changes in the market. But in 1996, even the dairy sector began to register modest gains in Poland, Romania and the Czech Republic. However, Poland has been experiencing a temporary setback in swine numbers, due to the hog cycle and rising feed prices in 1996. The principal exception to this recovery is Bulgaria, whose livestock sector remains in crisis.

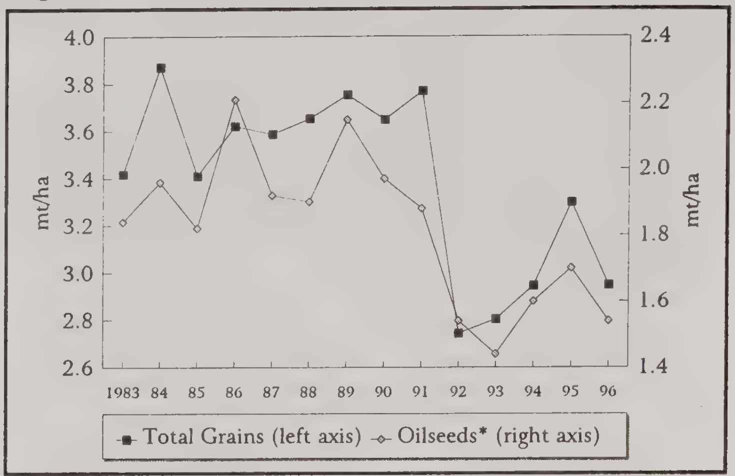
The rebuilding of the livestock sector will be a long, slow process, particularly for the cattle sector. During the early transition period, many of the highest quality breeding animals were slaughtered or exported. Thus, inventories are being rebuilt from a weak genetic base. This is just one factor that could make it difficult for the CEEs to meet EU quality standards. In addition, animals in the private sector are often kept in rather poor conditions and are fed whatever the households have on hand. Most livestock producers cannot afford feed concentrates, resorting instead to direct grain feeding. Given such feeding practices, most household livestock production fails to meet EU quality standards.

Expected Productivity Gains Not Yet Realized

Evidence of the expected productivity gains in CEE agriculture has yet to be seen. Since 1989 there have been only slight changes in area but increasing volatility in yields. Yields have decreased more than 12 percent for grains and almost 9 percent for oilseeds (figure 1).

Average yields have fallen principally because of the failure to use adequate chemical inputs, the lack of mechanization, and the lack of irrigation. Even though output prices have risen in several of the countries, most farmers still cannot afford to buy chemical inputs. There continues to be a shortage of small-scale machinery

Figure 1. CEE Grain and Oilseed Yields, 1983-96



* - Includes sunflowerseed and rapeseed.
CEE = Bulgaria, Czech Republic, Hungary, Poland, Romania, and Slovakia.
Source: USDA.

appropriate for the private farms. Many irrigation systems have been destroyed, and the investment needed to rebuild the systems has not been forthcoming. For all these reasons, CEE agriculture has been more vulnerable than the West to poor weather.

Unfinished Business Remains

Behind the lagging productivity of CEE agriculture is the "unfinished business" that must be resolved before EU integration becomes a realistic possibility. Among the areas that need to be addressed are:

Land reform and farm structure. The CEEs began the process of land restitution in 1991 and 1992. In some countries—Hungary, Slovakia, and the Czech Republic—the process is complete, although average farm sizes have not changed much as a result. Most of the new landowners had long since moved to urban areas and have chosen to lease their land to restructured cooperatives, leaving the landscape dominated by large-scale agriculture. There are unresolved issues surrounding land restitution in Poland, but these have not have had much impact since most of the land was privately owned throughout the Communist period.

In contrast, the process has been particularly disruptive in Bulgaria and Romania. The restitution of land in Romania began in 1990 as the cooperatives spontaneously disbanded. The process was codified into law in 1991. The redistribution of land took place very quickly as most former owners had good records. But the process created about 5 million landowners with an average of 2 hectares of land, with many households owning no more than half a hectare. Moreover, 5 years later many landowners still have not received permanent title to their land. Without titles they cannot offer collateral for loans, and they cannot sell their land. These landowners lack the cash to purchase adequate inputs and there remains a shortage of small scale machinery. Government policy remains ambivalent towards private agriculture. Officials have shown a distinct preference for maintaining the large-scale agriculture of the past and have strongly encouraged private land owners to either join an association or lease their land to one.

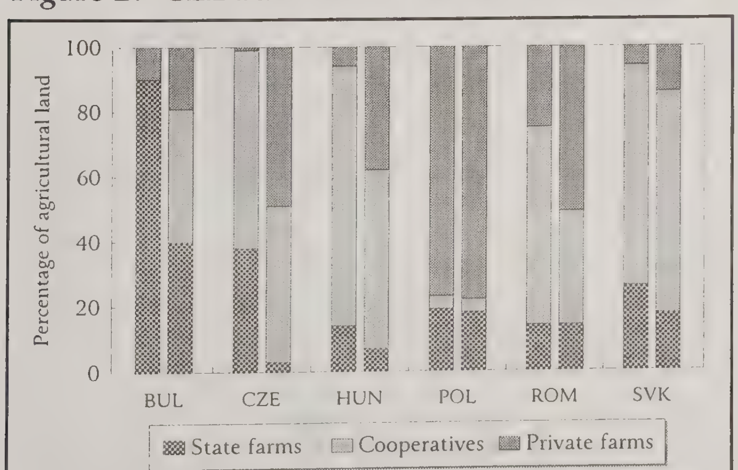
In Bulgaria the process remains stalled. The 1992 Land Law called for the liquidation of the cooperatives and the restitution of land to former owners within "real boundaries" if possible. About 70 percent of the land has been returned to former owners, but the owners of only 5 percent of that land have received final titles. Because of the uncertainty and other disincentives to produce, 800,000 hectares lie fallow (figure 2).

More ominous for the future in both countries, the liquidation of cooperatives and land restitution processes have led to a serious disinvestment in agriculture. Irrigation systems formerly maintained by the cooperatives were abandoned with the liquidation of the cooperatives. Municipalities have not taken on the responsibility for maintenance, and the private landowners do not have the money to maintain equipment or pay for water. In the meantime, the irrigation systems have been destroyed as parts and equipment have been stolen. In the livestock sector, the cattle sheds and poultry houses that formerly belonged to the cooperatives have been abandoned as animals were turned over to the private sector. These facilities have fallen into disrepair, and the capital needed to renovate these structures or replace them with smaller structures has not been forthcoming.

Non-agricultural rural development. At this time Poland, Bulgaria, and Romania find themselves with a large number of small, fragmented private farms. Many are suitable only for subsistence agriculture, too small to be viable economic units. Government officials would like to see the consolidation of these farms into larger more viable units. Consolidation is hindered in part by an undeveloped land market. But another issue is that many of these small farmers have lost jobs in industry and have no other source of income. Until they find alternative employment, these landowners will not be willing to sell their land and leave agriculture.

Restructuring the downstream sector. At the beginning of the transition, a serious obstacle to raising producers' incomes was the bottlenecks in the downstream sector—i.e. the purchasing, processing, and distribution of agricultural products. These functions were dominated by

Figure 2. CEE Farm Structure -- 1989 vs. 1994



1989 figures on left, 1994 on right. Key: BUL=Bulgaria, CZE=Czech Republic, HUN=Hungary, POL=Poland, ROM=Romania, SVK=Slovakia.
Source: European Commission.

Transition in the Farm Sector

CONFERENCE BOX #2

Wladyslaw Piskorz, Polish Ministry of Agriculture; Marian Voicu, Embassy of Romania; Frantisek Trojacek, Embassy of the Czech Republic

This panel examined the changes developing in Central & Eastern European agriculture from the perspective of the countries themselves. While significant progress has been made in transforming the agricultural economies of the region into a system of market-based, privately owned farming operations, much work remains to be done, and many tasks undertaken since 1989 have proven to be more daunting than was foreseen. Although the CEE countries faced divergent starting conditions at the beginning of the transition process, commonalities existed, and some general trends can be ascertained.

The collapse of the socialist command economies sent shockwaves through the region's farm sector. There was a steep decline in farm incomes, a dramatic increase in food prices, and a large increase in the rate of unemployment. In many cases, the farming sector was a buffer for unemployment. Many people formerly working industrial jobs shifted to farms and began working the land.

In most countries, privatization was a top priority. In Romania, for example, the decision to privatize agriculture was the first decision made after the revolution of 1989. Today 80 percent of agricultural land is in private hands in Romania and 90 percent in the Czech Republic. Poland was a rare case where land was never collectivized, and the issue there has been farm restructuring. Poland, like other countries, has seen a polarization of farm size, with the vast majority of arable land in either very small or very large holdings.

Some other problems experienced by the CEE countries include weak banking institutions, underdeveloped processing and marketing sectors, and limited access to EU markets. Despite these lingering obstacles, most CEE countries have turned the corner and returned to economic growth in the last 2 years. Those that haven't yet recovered will soon. In Poland, the recovery has been fueled by a dramatic growth in exports. And the region continues to be a big draw for foreign investors.

Ten countries of Central & Eastern Europe have signed Association Agreements with the European Union, which is committed to eventually offering membership to those that meet the political and economic criteria. Although no timetable for accession has been set, many countries have completed detailed EU questionnaires, and the European Commission has stated that accession negotiations will begin shortly (late 1997 at the earliest). In the interim, many CEE countries are turning their attention to the approximation of EU law, and some have implemented CAP-like policies to smooth the accession process.

inefficient, monopsonistic state-owned companies that were high-cost (and frequently in financial difficulties), and that tended to use whatever market power they had to hold down producer prices. It was often stated that the CEE processing sector subtracted value instead of adding it—the result of high processing costs that required substantial subsidies, and in view of the poor quality of the output.

The situation has changed to some extent in some of the CEEs. In Hungary, for example, the food processing industry is almost entirely privatized, with the help of foreign capital, and some Hungarians are confident that the industry is fully ready to compete in an enlarged EU on an equal footing with West European firms. Competition is also increasing in several sectors of the Polish and the Czech food processing industry.

Agricultural procurement and food processing in the southern countries remain largely in the hands of the state. Throughout the CEEs the purchasing and storage of bulk commodities, particularly grains, continue to be dominated by the state sector. These state companies tend to be heavily indebted and, because of financial problems, often work at a fraction of their capacity, raising per unit production costs.

The continued dominance of these firms helps to insulate domestic producers from the world market and hurts the competitiveness of the agro-food sector. Privatization is also one of the preconditions of EU accession. Large scale privatization has proceeded slowly in all CEEs except the Czech Republic. Most privatization has occurred through the start-up of new firms. In most of the CEEs, state-owned companies have been converted into commercial shareholding companies, and shares have been offered for sale. But because of their high indebtedness and outdated technology, there has been little interest. Mass privatization programs introduced last year in Bulgaria and Romania have drawn a lackluster response from the population.

EU Agricultural Trade Surplus Grows Under Europe Agreements

Despite agricultural trade preferences under the Europe Agreements, greater EU protectionism has given it a strategic advantage over its eastern neighbors. EU tariffs above the preferential quotas remain prohibitively high, preventing CEEs from further exercising their comparative price advantage in many bulk commodities. Meanwhile, less protectionist CEE tariffs allow competitive, high value-added EU goods to penetrate eastern European markets above preferential allotments.

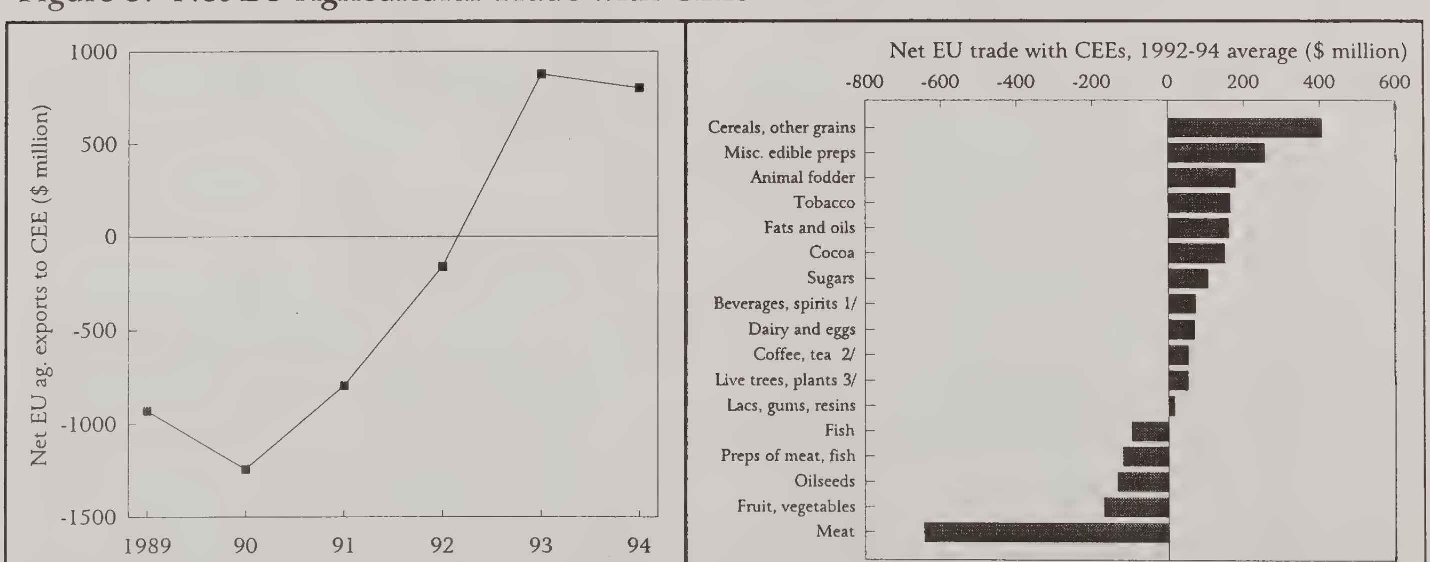
The Europe Agreements (see box on "The Europe Agreements") provide an important framework for preparing the CEEs for eventual EU membership, but have had mixed success in expanding CEE-EU trade. The EU has registered a growing agricultural trade surplus with the CEEs since 1992. Through 1994 the EU remained a net importer of CEE meats and meat products, fish products, and fruits and vegetables, while it maintained a net export position in the following Combined Nomenclature aggregates: eggs and dairy; cereals and other grains; fats and oils; coffee, tea, mate and spices; cocoa; sugars; beverages, spirits and vinegar; tobacco and manufactured tobacco substitutes; and "miscellaneous edible preparations" (figure 3).

According to Eurostat, in 1995 CEE agricultural imports from the EU exceeded the value of CEE agricultural exports to the EU by 1.3 billion ECU, up from 1.1 billion ECU in both 1993 and 1994.[3]

Of the CEEs, Hungary remained the only country in 1994 to maintain a trade surplus (of 0.4 billion ECU) in agricultural goods with the EU. For the first six CEEs to sign association agreements with the EU — Hungary,

[3]Eurostat. *Statistics in Focus: External Trade,* July 1996. (N.B.: these figures include the Baltic countries, which are major net importers of EU agricultural goods.

Figure 3. Net EU Agricultural Trade with CEEs



CEEs = Albania, Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia.
1/ Includes vinegar. 2/ Includes mate, spices. 3/ Includes cut flowers.
Source: Eurostat.

Poland, Czech Republic, Slovakia, Romania, and Bulgaria —the value of agricultural exports to the EU increased only 7.8 percent between 1989 and 1994, while imports from the EU increased 121.5 percent.[4] This resulted in the change from an overall net trade surplus of 1.07 billion ECU for these six countries in 1989 to a net trade deficit of 0.40 billion in 1994.

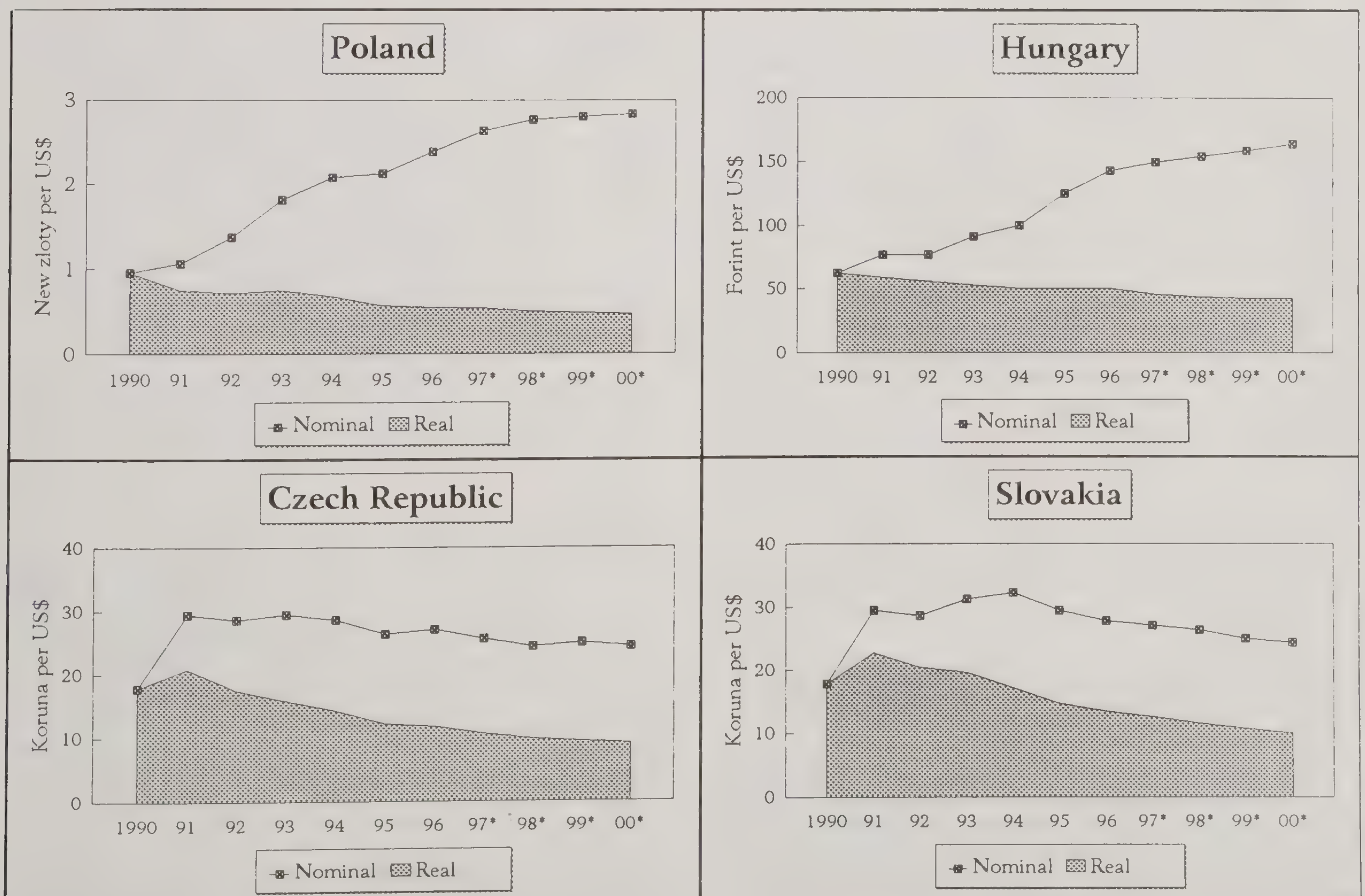
In recent years, while the value of net EU imports of CEE meats, meat products and preparations, and fruits and vegetables has been on the decline, net EU exports to CEE have increased considerably in the areas of miscellaneous edible preparations, animal fodder, tobacco products, cocoa, sugars, coffee, tea and spices.[5] CEE countries have managed to maintain their positive balance with the EU in oilseeds trade. The rise in EU exports of edible preparations is the most conspicuous of all, suggesting that high value-added products are largely responsible for the EU's growing trade surplus with the CEEs. These figures underscore the challenge for CEE processors to close the gap with their EU competitors in terms of product quality, packaging, and variety, in order to satisfy increasingly demanding and diversified consumers in their domestic markets.

Problems in implementing the preferences provided by the Europe Agreements have been the subject of discussions between the CEEs and the EU, and a number of causes are cited for the CEEs' apparent inability to take advantage of preferential access (see box). An additional factor contributing to the widening CEE trade deficit has been the appreciation of the *real* exchange rates of CEE currencies *vis-a-vis* EU (and other western) currencies. In the early years of transition, CEE prices were significantly lower than world prices, giving them a competitive trade advantage. CEE devaluations between 1990 and 1992 kept their agricultural prices well below world levels. However, since then a creeping real appreciation of CEE currencies has eroded their terms of trade and led to increased imports, not only in agriculture but across all goods sectors. The trend of real currency appreciation is expected to continue in the coming years, and could continue to have an adverse effect on CEE terms of agricultural trade with the EU. On the other hand, presently large negative balances on the current account of countries like the Czech Republic and Poland are also attributable to large imports of capital equipment and technologies. In the future, these investments should help boost CEE exports (figure 4).

[4] OECD, ed. *Agricultural Policies, Markets and Trade in Transition Economies: Monitoring and Evaluation 1996.* Paris 1996.

[5] Net EU exports of animal fodder to CEE countries have grown fastest in: i) oil-cake from soybean oil extraction; ii) meat and fish flours, meals and pellets, and; iii) pet food. Meanwhile, in 1994 the EU remained a net importer of oil-cake produced from vegetable oils other than soybeans: in particular, Poland and the Czech Republic were significant exporters of oil-cake from the extraction of rapeseed oil.

Figure 4. Nominal vs. Real Exchange Rates, 1990-2000



*Data for 1997-2000 are projections. Data for Poland reflect rates for new zloty, which replaced old zloty in 1995 at rate of 10,000 to 1.
Source: PlanEcon.

The Europe Agreements

The European Union has concluded a series of Association Agreements, also known as Europe Agreements, with several countries of Central & Eastern Europe. The agreements form the basis for the gradual integration of these countries with the EU. They cover five main areas: political dialogue, economic cooperation, financial assistance, approximation of laws, and trade liberalization. The first agreements were signed with Poland, Hungary, and Czechoslovakia in 1991, with the mutual trade provisions entering force the following year and the entire Agreements entering force in 1994. Agreements with other countries followed. The ultimate objective of the agreements is to lead to the membership of the Central & Eastern European countries in the European Union, as expressed by the European Council at the June 1993 Copenhagen Summit. To date, 10 CEE countries have concluded Europe Agreements, and all 10 have formally applied for Union membership.

The bilateral trade and cooperation aspects of the Europe Agreements provide for most-favored nation (MFN) treatment and the gradual elimination of selective quantitative restrictions over a 10-year period. Separate protocols cover "sensitive sectors," including agricultural products, clothing, textiles, coal and steel. For agricultural products, most concessions are phased in within 5 years and involve tariff reductions and quota increases. For example, beef, pork, mutton, poultry, and dairy products are subject to a 20-percent tariff reduction over 3 years, while import quotas will increase 10 percent per year for 5 years. However, trade in some commodity groups, such as grains, is not liberalized.

The two-way preferences were structured in such a way as to provide accelerated liberalization for CEE exports to the EU. Despite this, EU exports to the CEE have far outstripped trade in the opposite direction. In the first years of the agreements, lack of information and familiarity with EU procedures prevented the CEE countries from fully utilizing their allotted quotas. Another problem limiting CEE exports is the quarterly administration of preferential quotas, which hinders full utilization of annual quotas where seasonal commodities are concerned. Finally, the way tariff rate quotas are administered places the CEEs at a disadvantage. The quotas were allocated to EU importers, rather than CEE exporters. The exporters were therefore not able to specifically target the EU market.

Recently, the EU and the associated countries began renegotiating their Agricultural Protocols to expand preferences under individual Protocols in light of the final WTO Agreement on Agriculture.

Europe Agreements

Country	Date signed	Entry into force	Application for membership
Hungary	December 1991	February 1994	March 31, 1994
Poland	December 1991	February 1994	April 5, 1994
Romania	February 1993	February 1995	June 22, 1995
Bulgaria	March 1993	February 1995	December 16, 1995
Czech Republic	March 1993	February 1995	January 23, 1996
Slovakia	October 1993	February 1995	June 27, 1995
Estonia	June 1995	N/A	November 28, 1995
Latvia	June 1995	N/A	October 27, 1995
Lithuania	June 1995	N/A	December 8, 1995
Slovenia	June 1996	N/A	June 10, 1996

Note: "N/A" indicates Europe Agreement has not yet entered into force.

Conclusions

In preparation for EU membership it is important, first, that CEEs achieve their main goal of an economically viable agricultural sector. This involves eliminating upstream and downstream inefficiencies, such as overcapacity and large marketing margins, increasing labor productivity, and bringing producer prices in line with rising input costs on items such as energy, fertilizer, and equipment. It is questionable whether this goal can be reached by CEE governments in time for expected accession soon after the year 2000. Market policies and regulations in the name of domestic stabilization often act as a hindrance to this goal. Consumer-price regulation has perpetuated the producer cost-price squeeze, while continued government support of state-owned companies has hindered competition, prevented the exit of unprofitable firms, and perpetuated the problem of overcapacity in some sectors (such as dairy).

Only after production is fully brought by market forces into line with trends in domestic consumption, and has become more rationalized and efficient, should CEE

governments consider joining the EU. Otherwise, under a system of higher EU prices, additional burdens will be placed on government budgets and consumers to support inefficient producers and marketers. Furthermore, unless the CAP undergoes major reform, heavy support costs for CEE production and farm incomes could be borne by western EU members via Common Budget transfers.

CEE governments also need to weigh the costs and benefits of future adherence to the CAP as members of the European Union. One important benefit for CEEs to join the EU is to obtain full access to a vast market. By joining the EU, the elimination of considerable trade barriers could substantially increase CEE production and exports to their western neighbors. As noted above, most CEEs would receive net transfers to their coffers for producer subsidies from the EU budget. On the other hand, important economic drawbacks to membership include the higher food prices paid by consumers, a possible increase in long-term CEE contributions to the EU budget bloated by CAP commitments, and possible diversionary effects of joining the EU on CEE trade with CIS countries or other regional partners.[6] Poland, Bulgaria and Hungary all maintain a strong export position in CIS agricultural markets, while in 1994 Romanian and Bulgarian exports to non-European trading partners exceeded in value those to the present EU-15.

References

Cochrane, N.J. "CEE Markets Slow to React to World Grain Price Surge," *Agricultural Outlook,* AO-230, U.S. Department of Agriculture, Economic Research Service, Washington, D.C., June 1996, p. 22-25.

[6] Commonwealth of Independent States (the countries of the former Soviet Union minus the Baltics).

EU Opens Door to the East

The EU is preparing for enlargement with programs designed to ready the applicant countries for membership. Enlargement will significantly change the agricultural sectors in the EU and the CEEs. The EU may have to modify its agricultural policy to accommodate new members.

In the early days of their transition to democratic systems and market-oriented economies, the countries of Central & Eastern Europe (CEE) stated their goal of eventual membership in the European Union. Initially, the EU response was hesitant, given the internal and international activities of the EU at the time, such as the negotiation of the Treaty on European Union, the 1992 currency crisis, preparations for the EFTA enlargement, and the multilateral trade negotiations under the General Agreement on Tariffs and Trade. Since then, however, the EU has committed itself to enlargement to include countries of Central & Eastern Europe. Association agreements have been concluded with the majority of the CEE countries, and those countries have submitted formal applications for membership (see "Timeline of EU-CEE Economic Relations").

The EU's position on eventual accession largely reflects a political decision to encourage and cement the transition that the formerly planned systems have made toward democracy and market economics. The timetable of accession and the order in which the candidates will be considered, has not been stated. The EU has said that it will not consider applications for admission until the Intergovernmental Conference is completed. Negotiations between the EU and applicant countries are not expected to begin before 1998.

The EU has taken a multi-pronged approach in its preparations for enlargement to include CEE countries. A series of association agreements that provide mutual trade concessions, has been concluded, and the EU has funded an extensive program of technical assistance for the region. In addition, the EU has prepared a number of position papers and analyses of the impacts of enlargement, and confers regularly with the CEE countries on the requirements of eventual EU membership. The 1996 Intergovernmental Conference is now addressing institutional preparations for enlargement as well as the question of reinforcing political union.

EU PHARE Program Provides Assistance to CEEs

In the early days of the CEE transition, the EU established a program of financial and technical cooperation. The PHARE Program was begun in 1990, first to provide assistance to Poland and Hungary. The scope of the program was later expanded to provide assistance to a total of 11 CEEs. The EU's PHARE Program is designed to encourage political and economic reform in the CEE countries, in preparation for EU membership. By 1999, the PHARE Program will have committed some $11 billion.

The PHARE Program has sponsored a number of projects aimed at improving agricultural structures and market mechanisms in the CEEs, improving effective food production, processing and distribution, and improving infrastructure. As part of the pre-accession strategy detailed at the 1994 meeting of the EU's European Council in Essen (Germany), the program was permitted to orient more of its funds to supporting investment projects in the region. Additional assistance is available through the European Investment Bank, and the European Bank for

The Role of Technical Assistance

CONFERENCE BOX #3

Richard Lacroix, World Bank; Carl Hammerdorfer, Volunteers in Overseas Cooperative Assistance; Jim O'Meara, Emerging Markets Office, USDA, Foreign Agricultural Service; Cheryl Christensen, USDA, Economic Research Service

This panel focussed on the role of technical assistance in promoting the reform process in transitional economies. The three panelists represented organizations with quite different approaches to technical assistance, yet their programs all share certain similarities. The main similarity is the commitment of all the programs to provide information on the farm sector. The importance of information dissemination to farmers, agroindustry, and policymakers was underscored by all three speakers, as was the mutually beneficial nature of technical assistance.

Hammerdorfer outlined the programs of Volunteers in Overseas Cooperative Assistance (VOCA), a development agency and information provider for farmers, agribusiness, banking, and policy- and decision-makers. These programs have shifted their emphasis to agribusiness in recent years, and have evolved into more intensive sector-specific projects. The mission of the Foreign Agricultural Service's Office of Emerging Markets is to provide technical assistance in order to promote U.S. exports. Every project undertaken must meet this criteria of market development. Its objectives are to improve the policy environment for business, develop market information, and enlist private sector involvement. These objectives are complemented by those of ERS' technical assistance programs, which seek to improve short-term market forecasting. This is an important contribution to the transition because the dissemination of timely and reliable information is a crucial aspect of an open economy.

Reconstruction and Development, the majority of whose stockholders are the EU and its member states.

Access to EU Markets Remains Limited

The conclusion of association agreements, referred to as Europe Agreements, with the CEEs was a step toward their membership in the EU (see box on "Europe Agreements"). The Europe agreements are designed to respond to the needs of the CEEs prior to their eventual accession, allowing them time to continue their economic and political reforms. The agreements also enable the EU to postpone serious discussions about accession.

Despite the agreements, the CEEs have experienced difficulties expanding agricultural exports to the EU. The CEEs have also found themselves hindered by protectionist actions by the EU. The imposition of temporary import bans on livestock and livestock products in 1990 seriously hurt the ability of CEEs to export to the EU at a time when herds were being culled and livestock and livestock products were available. The ban was imposed when cattle from Yugoslavia infected with foot and mouth disease were imported into Italy. All the CEEs, including those, such as Poland, that considered themselves FMD free, were covered by the ban. The trade impact was very broad, in that the ban covered dairy products and not just live animals and meat.

Most recently, the EU has suggested negotiating voluntary export restraints on live cattle exports from the CEEs, because of the difficult situation on the EU beef market in the wake of the bovine spongiform encephalopathy (BSE) crisis. Under the terms of the Agreement on Agriculture, the EU cannot unilaterally suspend the tariff rate quota it created, and which is chiefly filled by animals from CEE countries.

CEEs Align Policies with EU Legislation

At the Essen Council, the Commission was given the task of preparing a White Paper on CEE enlargement. The paper itself was presented in May 1995. The goal of the White Paper was to help the six associated countries (the Visegrad Four, Bulgaria, and Romania) prepare to operate under the EU's internal market. The White Paper proposed that the CEEs begin to align their economic policies with those of the EU. This alignment would smooth the way for eventual accession, which will require the complete adoption of all EU legislation, called the *acquis communautaire,* immediately upon becoming EU members.

This alignment of policies requires the CEEs to make adjustments beyond those required by their transition to market economies. The White Paper identifies key measures in each economic sector, and suggests a sequence for the CEE countries to adopt legislation similar to the EU's. The White Paper also highlights and describes the structures necessary to make the legislation effective. Approximately 1,000 measures affecting the free movement of goods are identified in the paper, and some 200 of these are considered key measures for alignment.

In the agricultural sector, the White Paper specifies common rules governing the movement of live animals, meat and meat products, fruits, vegetables, and plants. These measures will affect a wide range of activities in the farming, production, and processing industries. As concerns agricultural markets, the measures relate primarily to the provision of quality standards and labeling requirements. Examples of the kinds of legislation the CEEs should begin to approximate are:

- gradual introduction of quality standards and rules on presentation and labeling;
- measures to achieve free price formation and proper price reporting;
- measures to encourage the development of producer organizations, especially for fruits and vegetables;
- setting of animal welfare conditions, for example, on battery cages for hens, calf crates, and animal transport;

- rules on diseases like horse fever and scrapie, and rules on trade where risk of diseases like rabies and infectious bovine rhinotrachitis vary;

- provisions to improve the inspection infrastructures, including human and technical resources required to check imported agricultural products, especially live animals;

- determination of microbiological standards for products like minced meat, and milk and milk products;

- classifications of wine varieties, regional specifications, and standards of wine making practices;

- qualification of inspection personnel;

- laying down structural conditions for small slaughterhouses.

The Agricultural Context of Enlargement

Economic implications, including the implications on the EU's farm sector, have taken at best a secondary importance in the enlargement question. In fact, it is doubtful whether the EU farm sector would strongly support the accession of Central & Eastern European countries. Like the United States, the EU provided food aid in the early days of the transition, when CEE agriculture and food markets were badly disrupted. At that time, EU farmers regarded the CEEs as important potential markets. However, the subsequent agricultural developments in the CEEs demonstrated that these countries were potential competitors rather than customers. The EU farm sector has already expressed serious concerns about the CEEs. For example, EU farm organizations opposed granting increased access to EU markets for CEE products during the negotiation of the Europe Agreements.

The EU Commission has prepared or commissioned a number of studies on enlargement to include the CEEs, and their findings reveal a divergence in viewpoints between the agriculture sector, as represented by Directorate General VI, and other parts of the Commission. Directorate General II, which deals with financial issues, commissioned a series of papers on enlargement by recognized experts in agricultural economics. DG VI prepared its own Agricultural Strategy paper, adopted by the Commission in November 1995, examining alternative approaches to preparing for enlargement.

The Agricultural Strategy paper identified three key problem areas in CEE agricultural sectors: the lack of capital, the problematic farm structure, and the chronic deficits in the processing, packaging, wholesaling, and retailing sectors. It assessed the impact of CEE enlargement with the current CAP mechanisms. It recommended a number of actions to improve EU-CEE cooperation in the field of agriculture prior to accession, as well as directions for the development of the CAP to accommodate the CEEs.

The Commission examined three different scenarios to gauge the impact of the CAP on CEE agriculture, on one hand, and of enlargement on EU agriculture. The first scenario looked at enlargement under the current CAP, the second at enlargement under a radically reformed CAP, and the third at a moderately reformed CAP. Enlargement under the status quo would add to existing market imbalances, and make it impossible to comply with Uruguay Round commitments. A radical reform of the CAP—eliminating support prices, quotas and other supply management, and providing only direct income support and environmental payments—would be politically difficult to obtain, and could disrupt rural communities.

The Agricultural Strategy paper favors the third approach, namely, continuing the reform efforts begun in 1992, and extending them to cover other sectors. The development of the 1992 reforms implies further movement away from price support and toward greater use of direct compensatory payments. The Commission considers that this approach would encourage the increased EU agricultural competitiveness needed to meet the international challenge, while causing minimal disruption.

The Commission feels that the 1992 reforms have had considerable success in resolving market imbalances, particularly in the grains sector. The substantial reduction of intervention stocks is an indication of this success. Even the beef sector, where the Commission felt that the reforms may not have been sufficient, was in good shape prior to the disruption brought about by the most recent BSE crisis.

The paper recommends increasing EU market access for CEE agricultural products in the pre-accession phase, by further expanding the tariff rate quotas, allowing the CEEs to transfer unused quotas among themselves, and abandoning the minimum entry price requirement for fruits and vegetables within the tariff rate quota. In addition, the paper calls for designing a structural adjustment package for the CEEs to improve the efficiency of downstream activities directly linked to primary agricultural output. A package of accompanying measures, covering afforestation, early retirement programs, and farm improvement schemes, was also recommended.

Enlargement To Transform European Agriculture

Enlargement will increase agricultural output in Central & Eastern Europe (CEE), particularly in the livestock sector. CEE demand for feedstuffs will increase, creating opportunities for additional U.S. corn and oilseed exports. An enlarged EU will become an even larger wheat exporter following accession, while meat production will shift to the CEE countries.

The EU has stated that it will enter into membership negotiations with the 10 countries of Central & Eastern Europe with which it has association agreements. At this time, no timetable has been set for enlargement, and it is unknown whether all CEE countries will become members at one time, or whether there will be a phased accession of groups of countries. The Visegrad countries (Poland, Hungary, the Czech Republic, and Slovakia) were the first countries to sign association agreements and, as they are the furthest along in economic and political transition, they are generally considered the leading candidates for early EU entry.

It is increasingly likely that the enormous impact these countries will have on the EU budget will precipitate a substantial reform of the Common Agricultural Policy. The purpose of such a reform would be twofold: to reduce the budgetary impact of bringing several large agricultural-producing countries under the CAP and to facilitate a smooth integration of the politically sensitive EU-15 and CEE farm sectors. At this time, there are no firm proposals for reforming the CAP, but there is much speculation over the changes that will have to be implemented.

Although there is much uncertainty as to how the CEE and EU economies may change in the coming decade, insights into the likely impacts of enlargement can be developed by analyzing some possible outcomes. Two different scenarios were created for this study: one in which EU policies remain as they are today, and one in which the CAP is liberalized. Both scenarios are based on the assumption that the four Visegrad countries will join the European Union in 2002. According to most EU observers, this is probably the earliest date that prospective members could be admitted. It is assumed that the CEEs will adopt EU policies and prices fully and immediately, as the European Free Trade Association (EFTA) countries of Austria, Finland, and Sweden did when they joined the EU in 1995. It is unclear whether this will happen, because Spain and Portugal, more similar in their state of development to the CEEs than the former EFTA countries, had long transition periods during which CAP provisions were gradually applied. Nonetheless, full and immediate implementation of CAP provisions permits the study to be interpreted as a comparative static analysis, relevant for the early 2000s (figure 5).

The analysis was carried out using the European economic simulation model (ESIM). This model is used to generate projections of production, consumption, and trade for ERS' annual long-term forecasting exercise (baseline), which assumes no changes to policy or EU membership. The results of the EU enlargement scenarios are compared to the baseline forecasts for the separate CEE countries and the EU-15.

Figure 5. Scenario Assumptions

	Baseline	CAP Scenario	Revised CAP
New Members	-----	Visegrad Four	Visegrad Four
Accession Date	-----	2002	2002
CAP Orientation	Unchanged	Unchanged	Reformed

Visegrad Four are Poland, Hungary, Czech Republic, and Slovakia.

Our analysis incorporates macroeconomic forecasts of GDP, inflation, and exchange rates from DRI/McGraw-Hill. These GDP forecasts assume no change in EU membership. Accession is likely to accelerate income growth, which will be partly offset by inflation. We believe the overall impact of accession on CEE GDP would be positive and that after the first 2 years of accession, CEE GDP would grow at an annual rate roughly 2 percent higher than the DRI baseline estimates.

Current CAP Scenario: Enlargement Results in No Change in the CAP

The first scenario assumes that the Visegrad countries join the EU in 2002 under the current CAP. As in our baseline for the EU, the set-aside rate for the CEEs is fixed at 15 percent of arable land. It is assumed that the CEEs will receive compensatory payments, set at their current levels, adjusted for inflation. This assumption is subject to some debate. It is possible that upon joining the EU, CEE producers will be eligible for intervention and export subsidies, but will not receive compensation payments. These payments were designed to compensate producers for price declines, such as those experienced by EU producers during the 1993-95 support price declines under CAP reform, and by producers in Austria, Finland, and Sweden upon joining the EU in 1995. However, CEE producers are unlikely to experience price declines upon application of CAP provisions.

Prices of many agricultural commodities in the EU are higher than average world prices. This is due to the effect of CAP instruments, including intervention prices, export subsidies, and high import protection, to protect farmers'

incomes. In the CEEs, prices for most agricultural commodities are at or below world prices. This price difference is typically due to institutional rigidities (see "Central & Eastern Europe Tackles Challenges of EU Integration" elsewhere in this report) and quality differences between products in the CEEs and those from more developed countries.

To estimate the impact of CEE accession under the current CAP, one must first estimate the price differences between the CEEs and the EU. Evaluation of price differences, and the extent to which these differences diminish after accession, provide the basis of the analysis. The largest price gaps exist in the livestock sector, particularly for beef and pork. The EU highly supports its beef sector and protects its pork sector, so its prices are higher. The quality of CEE meats is also inferior to that of Western Europe and there is less demand for meats, which depresses prices relative to EU levels.

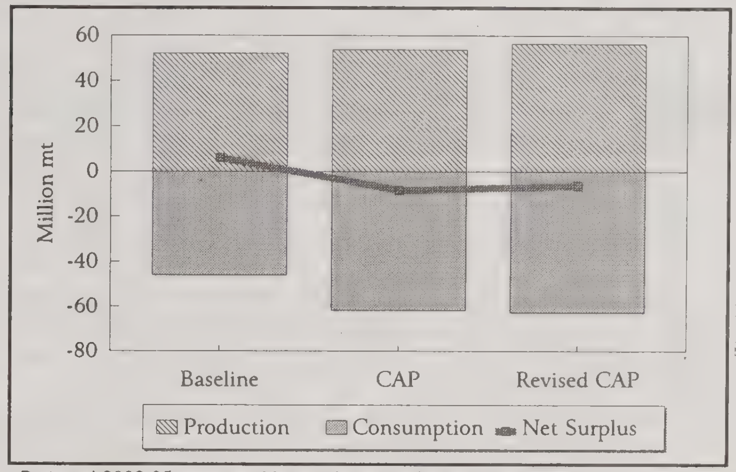
Livestock. The results of the current CAP scenario suggest that the largest increases in CEE production would take place in the livestock sector, where pre-accession price differences are the greatest. While increased prices stimulate production, they also discourage consumption. Prior to economic liberalization, meat consumption was very high in the CEEs due to artificially low meat prices. When prices were liberalized, meat became a luxury rather than a staple and meat consumption plummeted. As incomes have risen, meat consumption has begun to increase. However, if the CEEs adopt EU prices, consumption would again decrease. The increase in CEE incomes would be dwarfed by the large increase in the price of meats.

The increase in meat production and the drop in meat consumption would create an exportable surplus of meat in the CEEs. While it is likely that the EU-15 could absorb some of the excess pork and poultry, it is unlikely that it could absorb any beef due to an already existing surplus.

Grains. The increase in CEE meat production would lead to increased demand for grains and protein meals for feeding. However, because the price differences for these commodities are not as great as the price gaps in the livestock sector, grain and protein meal production gains are not expected to be as large as those for livestock. The adoption of the EU's 15-percent mandatory set-aside offsets the productivity gains from higher prices. The baseline forecast suggests that the CEEs will be self-sufficient in grains by 2002. If they were to adopt the current CAP, large increases in the demand for grains and meals for feeding would greatly outweigh the slight increase in grain production. Thus, the CEEs would have to import some grains and meals.

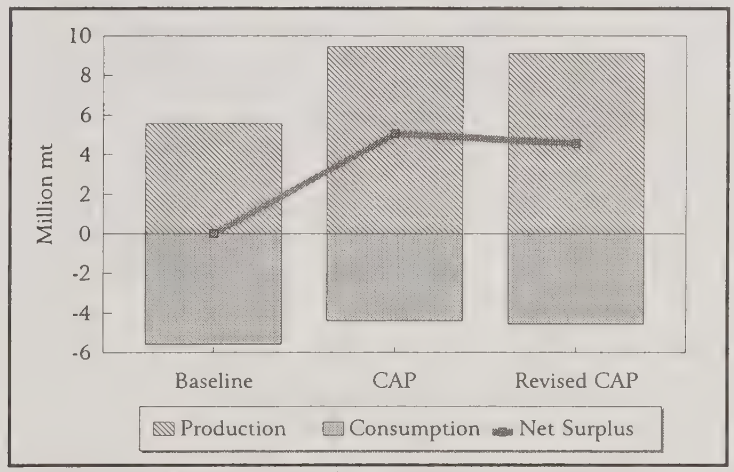
Because the EU-15 is a surplus producer of many grains, much of the CEEs' grain deficit will be met through imports from the EU-15 countries. However, the EU, already an importer of corn and soybean products, will not be able to fill the CEEs' need for corn, other coarse grains, soybeans, and soybean meal. Demand for these goods must be met by third-country imports, some of which could come from the United States (figures 6 and 7).

Figure 6. Visegrad Grains Under Different Scenarios



Projected 2002-05 averages. Net surplus = production minus consumption.
Visegrad Four are Poland, Hungary, Czech Republic, and Slovakia.

Figure 7. Visegrad Meats Under Different Scenarios



Projected 2002-05 averages. Net surplus = production minus consumption.
Visegrad Four are Poland, Hungary, Czech Republic, and Slovakia.

Offering membership to the Visegrad countries without altering existing CAP mechanisms would have a major impact on the EU budget. A number of studies have estimated that it would cost the EU between $2 billion and $57 billion to bring the Visegrad countries into the EU under the current CAP. Based on the results of our current CAP scenario, enlargement could cost the EU an estimated $3 billion annually in support costs alone, to cover compensatory payments, minimum levels of intervention buying, and export subsidies at GATT/WTO limits. Structural funding to improve agricultural infrastructures will be far more expensive, with estimates starting at $7 billion. The CAP budget was approximately $30 billion in 1996. Enlargement could easily add an additional $10 billion or more to an already strained CAP budget. Given the mood of austerity prevailing in European capitals on the eve of the Economic and Monetary Union (EMU), it is unlikely that the CAP could remain unchanged after enlargement.

Reformed CAP Scenario: Lower EU Prices Mean Smaller CEE Production Increases

In the second scenario, it is assumed that a reformed CAP will have no set-aside requirement and no internal EU

The Cost of EU Membership

A number of studies have estimated the cost of extending EU membership to the Visegrad countries. The estimates have ranged from $2 to $56.7 billion. The large variations are due to significantly different assumptions. The most conservative estimate (Tangermann and Munch) does not include compensatory payments for livestock producers or intervention buying of any commodity. It also assumes fairly high world prices that decrease the gap between EU prices and world prices, minimizing the cost of export subsidies. Additionally, the lower bound of the Tangermann and Munch estimate assumes no compensatory payments would be extended to the CEEs.

The highest estimate, by Anderson and Tyers, assumes high support levels and allows world prices to fall as the CEEs increase their production. The decline in world prices results in high export subsidies. Had Anderson and Tyers imposed the Uruguay Round's constraints on export subsidies, their estimate would have been lower.

The CEPS study used 1990 data and consequently did not account for the 1992 CAP reform or the Uruguay round GATT agreement. The U.K.'s Ministry of Agriculture, Fisheries, and Food included intervention buying, export subsidies, and direct payments to farmers in their estimates, but not the limitations of the GATT agreement. If all of the studies had imposed the constraints of the GATT agreement, the estimates would likely be lower (figure 8).

Figure 8. Cost Estimates for EU Enlargement

STUDY	Estimated annual cost of enlargement ($ billion)	CAP reform	GATT agreement
1. CEPS (1993)	6.6 - 50.8	No	No
2. Anderson & Tyers (1993)	66.3	Yes	No
3. UK MAFF (1993)	9.1 - 22.2	Yes	No
4. UK MAFF (1994)	8.3 - 34.1	Yes	No
5. Tangermann/Josling (1994)	5.9 - 11.9	Yes	Yes
6. Tangermann/Munch (1995)	2.6 - 4.9	Yes	Yes

NOTE: Studies listed in the table provide cost estimates for the EU's agricultural budget only. Estimates vary depending on the assumptions used for each study. The table indicates which studies incorporate a further round of CAP reform and/or GATT restrictions under the Uruguay Round Agreement.

1. Brenton, P. and D. Gros. "The Budgetary Implications of EC Enlargement," CEPS Working Paper No. 78. 1993.
2. Anderson, K. and R. Tyers. "Implications of EC Expansion for European Agricultural Policies, Trade, and Welfare." CEPR Discussion Paper No. 829. 1993.
3 & 4. UK Ministry of Agriculture, Fisheries, and Finance. "Agricultural Budgetary Implications of Accession by the Countries of Central and Eastern Europe to the EU." Two draft reports. London, 1993 and 1994.
5. Tangermann, S. and T.E. Josling. "Pre-Accession Agricultural Policies for Central Europe and the EU." Study for DG I of the European Commission. Brussels, 1994.
6. Tangermann, S. and W. Munch. "Agriculture in Poland, the Czech and Slovak Republics, and Hungary and Possible Evolutions in the Medium-Term Using the ESIM Sector Model." Final report on a study done for DG I of the European Commission. Goettingen, 1995.

price supports; the EU would move to world prices for all commodities. This scenario also encompasses the prevailing expectation that the EU will not extend compensatory payments to CEE farmers. Some of the EU money that would have funded compensatory payments will likely be shifted to structural reform programs to improve the agricultural infrastructure of these economies. The EU may continue to support farmers, but it is assumed that the support will be completely decoupled from production, i.e. support payments will not affect farmers' planting decisions.

In this scenario, in contrast to the previous scenario, prices will change in the EU as well as in the CEEs. Adopting world market prices would trigger a decline in prices for EU farmers, and an increase for CEE farmers in most sectors. Under the reformed CAP, because EU prices fall to world levels, CEE price increases would not be as large as in the current CAP scenario. Consequently, production gains should be smaller than in the current CAP scenario, except in the crops sector, where elimination of the set-aside requirement will increase planted area.

Grains. The only sector where some CEE prices decline with the move to world prices is the grain sector. Hungary, which supports its grain sector at prices slightly higher than those in the EU, will experience the largest price decline. Czech and Slovak corn prices are also somewhat higher than EU prices, and will decline as they move to world prices. Under the reformed CAP, EU grain prices fall to world price levels, resulting in a large decline in EU barley and corn prices, but a minimal decline in the price of wheat, which is forecast in the baseline to be close to the world level by 2002.

The largest increases in CEE grain prices are for wheat, prompting an expansion in CEE wheat production. Although the Hungarian wheat price is not expected to change, wheat production will increase because other grain prices are falling, making planting wheat a more attractive alternative. Because there is no mandatory set-aside under the revised CAP, wheat production in the CEE countries is expected to exceed that under the current CAP scenario and the baseline. CEE prices for coarse grains will decrease (Hungary, Czech Republic, Slovakia) or increase (Czech Republic) far less than the wheat price. Consequently, coarse grain production is not expected to exceed baseline levels or current CAP scenario estimates, even with the elimination of set-aside.

Despite lower prices, EU-15 grain production is projected to surpass the baseline level, due to the elimination of

Can the CAP Withstand Enlargement?

The EU's Directorate General for Agriculture (DG VI) has stated that the CAP can be extended to the CEE countries with gradual modifications, following the example of the 1992 MacSharry reforms. However, the pressures of multilateral trade commitments and fiscal constraints may conspire to accelerate liberalization of the CAP.

The chief problem posed by enlargement is the increased expenditure it would entail, were current policies applied. The CEEs are expected to be net recipients of EU funds, rather than net contributors, but the exact cost of enlargement will depend largely on how CAP policies are applied to the new member states. Even if the CEE countries do not benefit from producer payments (for grains, oilseeds, protein crops, and beef cattle), under current policy mechanisms CEE products would be eligible for intervention and export subsidies. The quantity and type of regional and structural aid will also influence the overall budgetary impact.

Another constraint is the need for the European Union and individual CEE countries to respect their GATT commitments under the Uruguay Round agreement. This agreement placed limits on export subsidies and external support. The 1992 reforms reduced EU internal support (excluding "blue box" direct payments) enough to meet the EU's GATT commitments. However, the CEEs cannot increase support to their agricultural sectors. The calculation of internal support is measured by quantity of production supported, and the monetary value of support given. The application of the CAP to CEE countries would likely increase both the level of per unit support, and the total quantity of products eligible for support.

The expected increase in support for CEE agriculture after EU accession will in turn spur increases in output. Increases in production of some commodities could lead to surpluses that could not, under the GATT agreement, benefit from export subsidies. Higher prices to consumers under the CAP would limit or reduce domestic consumption, exacerbating the situation. Surpluses would put pressure on the CAP budget, EU internal prices, or both.

Given the constraints imposed by the budget and GATT commitments, the continuation of the 1992 reforms to cover more commodities may prove to be insufficient. Negotiations to continue WTO trade liberalization are scheduled to start in 1999. Thus, the EU will be considering policy changes necessary for enlargement and for WTO negotiations simultaneously.

The EU will also have to consider the impact of enlargement on EU farmers. Extension of current CAP mechanisms could very well encourage overproduction in the CEEs, putting competitive pressure on western European farmers. As a result, production and trade could shift within an enlarged Union. Of course, current EU members will want guarantees that their agricultural sectors will not be threatened. For example, Agricultural Commissioner Franz Fischler has suggest that EU support payments be modulated in the future to favor small farmers.

The EU will have to find a balance between the interests of its farmers and its political goal of eastern enlargement. Already, the Commission is looking at the next round of enlargement differently than the 1995 enlargement (Austria, Finland, and Sweden). The Commission elected not to extend compensatory payments to CEE farmers (because most prices are expected to increase, not decrease), but instead devote large sums for structural support. The Commission also envisions long transition periods for the new countries, unlike the EFTA countries' full and immediate application of CAP mechanisms on January 1, 1995. Long transition periods would allow the CEEs to adopt stringent EU standards with only minimal economic and social disruption, but could hinder the free movement of goods between the new members and the EU-15.

set-aside. The EU wheat price is expected to decline less than prices of the other grains, causing EU wheat production to increase the most, as area formerly allocated to other grains is shifted into wheat production. Under the reformed CAP, the EU-15, already one of the largest wheat exporters, will have the potential to increase its wheat exports. EU-15 coarse grain production will also increase slightly with the elimination of the set-aside.

Lower prices stimulate consumption. By moving to world prices, the previously supported corn price drops by one-third in Hungary. This results in a large increase in corn consumption relative to the baseline or current CAP scenarios. This trend is consistent for the other CEE countries as well. As prices move to world levels, corn becomes a more affordable feed relative to wheat and corn consumption increases. Meanwhile, in the EU-15, the growth in corn consumption is also expected to out pace corn production. This would create large corn deficits in the EU-19 as corn prices fall and meat production increases. Consequently, an EU-19 will likely require even more corn imports than today to meet internal demand. It is possible that the United States could increase corn exports to the region.

If the CAP were reformed according to the scenario, the EU-19 could increase wheat exports above the baseline forecast. With the incentive of higher prices, CEE farmers could increase their output to become surplus producers as well. Commensurate with the movement to world prices, there would be no need for the EU to subsidize wheat exports, as it has in the past. Thus, the EU would no

longer be constrained by its GATT commitments on subsidized exports.

Livestock. Under the reformed CAP, CEE livestock production would exceed baseline estimates as prices increase to world levels. Production gains would not be as large as under the current CAP because world prices are below EU livestock prices under the current CAP. Consequently, the shift to world prices would lead to a decline in EU-15 livestock production. Because the EU poultry price is close to the world price, EU-15 poultry production is not expected to change. Overall, results suggest that as EU-15 and CEE prices converge, pork and beef production will shift from the former to the latter.

Higher CEE livestock prices will reduce CEE meat consumption. The decline would not be as large as under the current CAP because the price increases would not be as large. Conversely, as EU livestock prices drop to world levels, EU-15 consumers will increase their meat consumption. The increases would be greatest for beef and pork, as their prices decline the most.

Currently the EU-15 has large exportable surpluses of beef and pork. In the reformed CAP scenario, as production declines and consumption increases, the EU-15 would be in deficit. In the baseline scenario, the CEEs will be self-sufficient in pork and net importers of beef. However, the increase to world prices promotes production and discourages consumption, leaving the CEEs with exportable surpluses of all livestock products. Under the reformed CAP the EU-19 would become a net importer of beef, but would have slightly larger exportable surpluses of pork and poultry than in the baseline forecast.

Conclusions

Predicting the impact of CEE accession to the European Union is difficult due to the number of variables bearing on the enlargement issue. With this challenge in mind, we analyzed two scenarios representing opposite sides of the spectrum of possible future orientations of European agricultural policy: one where current policies are applied to the CEEs, and another where the enlarged EU-19 farmers face world prices. We compared our results to the ERS baseline forecasts also generated using our ESIM models. This preliminary analysis does not include world price effects. Large increases in CEE production could result in lower world prices, dampening CEE production gains slightly. However, our results do predict the direction of production shifts. Our results suggest that the agricultural economies of both the EU-15 and the CEE countries are likely to experience major adjustments as a result of EU enlargement.

After enlargement, the EU-19 becomes an even larger wheat exporter, while potentially importing more corn. The production of all meats will shift somewhat from the EU-15 to the CEEs as livestock prices increase in the CEEs and decrease in the EU-15. The EU-19 will continue to have some exportable surpluses of pork and poultry.

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Enlargement Alters Outlook for Trade and Investment

Central & Eastern Europe is an expanding market for U.S. farm exports and investment. However, enlargement could lead to increased protection against goods from the United States as CEEs adopt EU legislation. Rising income growth following enlargement could expand trade opportunities, specifically for oilseeds, oilseed products, and some feedstuffs.

Trade Climate Improving, Longer-term Outlook Uncertain

Economic growth in the short and medium term, and membership in the European Union in the long term, will shape the outlook for agricultural trade in the Central & Eastern European countries (CEE). After several years of economic decline, income growth is positive in most countries. In the early transition years, demand for food and agricultural products fell sharply as food prices, heavily subsidized under the former regimes, rose rapidly as prices were freed. Sustained economic growth should drive a recovery of demand for agricultural goods that may stimulate demand for imports.

Many of the CEE countries are middle- to low-income countries where income growth has considerable potential for increasing consumption of high-value and processed products. In 1994, high-value products (a category that includes such diverse products as poultry, dairy products, feed grain products, seeds, oilseed meal, vegetable oil, fruits and vegetables, and beverages) accounted for two-thirds of U.S. agricultural exports to this region. U.S. exports to the CEEs have been led by poultry, whose gains could reverse if the CEE poultry sector recovers. However, any expansion of CEE livestock and poultry production will raise feed use, which could be beneficial for U.S. feed product exports.

U.S. Near-term Export Outlook Positive

U.S. exports to Central & Eastern Europe are estimated at $398 million in fiscal 1996, up from an alltime low of $283 million a year earlier. Exports to the region are still below the levels of the 1980's, but now appear to be on a

definite upward trend, primarily the result of small increases in exports of grains and animal products.

U.S. exports of grains, particularly wheat and corn, are expected to rise significantly in 1996/97, following an extremely poor grain crop in most of Eastern Europe. Although up substantially in volume, the value of U.S. grain exports will be only slightly above last year's level because of declining world prices. The main destinations for U.S. wheat and corn exports will be Poland, Bulgaria, and the former Yugoslav republics. However, Bulgaria's ability to import will be severely constrained by its continuing shortage of foreign exchange reserves.

U.S. exports of oilseeds and products are projected to rise in fiscal 1997, particularly for Poland, Romania, and the former Yugoslav republics. Total CEE imports of soybeans are expected to reach 315,000 tons in 1996/97, up from 285,000 tons in the previous year, due mainly to a poor rapeseed harvest in Poland. However, the United States has been facing increased competition from Latin American suppliers and will have to work harder to keep this market share. U.S. soymeal exports to the CEEs are expected to decline again in 1997, as they have over the last few years due to preferential access granted to EU soymeal under the association agreements. The United States has never had a large share of the CEE soymeal market.

Exports of poultry, the largest component of U.S. exports of animal products to the CEEs, are estimated at $70 million in fiscal 1996. U.S. poultry exports to the CEEs have slumped in the last 2 years due to increasingly protectionist measures taken by the CEEs. The largest buyers of U.S. poultry in fiscal 1994 were Poland and Romania. However, in fiscal 1995 Romania imposed a 143-percent tariff on poultry imports, while Poland implemented a variable levy. Since signing onto the WTO agreement, Poland abolished the variable levies and opened a tariff rate quota of 8.5 percent of the previous year's production. This equates to 28,900 tons for 1996 and a similar volume for 1997. Fiscal 1996 poultry exports to Poland, about 65,000 tons, far exceeded that amount. Romania's tariff remains in effect and has effectively blocked all U.S. sales of poultry meat. The only exports in this category that remain are sales of baby chicks.

The CEEs have become a more difficult market for the United States. Traditional U.S. exports of bulk commodities, particularly grains, have declined since 1990 and fluctuate considerably from year to year, depending on domestic CEE grain production. On the other hand, the share of high-value exports in U.S. exports to Eastern Europe has been rising. Poultry claims the largest share of these high-value exports. These exports have become more difficult with increasing protectionism. However, they remain strong and could still grow in coming years. In addition, exports of variety meats and hides and skins are beginning to recover, and U.S. companies are finding markets for new products not traditionally imported by the CEEs. These include popcorn, other processed grain products (ready to eat cereal, etc.), and horticultural products, especially nuts.

Increased Protection, Competition Will Influence Trade

Despite the boost to agricultural trade expected from growth of the CEE economies, there remain significant obstacles to expanded trade with the CEEs. Government intervention, increased protection, and stiff competition from the EU will alter an otherwise favorable picture for increased U.S. agricultural exports to the CEEs.

Government intervention in the market for agricultural products in the CEEs is widespread, leading frequently to increased protection from imports and restrictions on exports. In all CEE countries, there are state-guaranteed price floors for various products, although the degree of effectiveness of price floors varies from country to country. Because of tight government budgets, these price floors tend to be supported less through government purchases and more through border measures, such as tariffs and export subsidies.

When the countries of Central & Eastern Europe began their transition toward market economies in the early 1990's, they had few mechanisms in place to regulate imports when central planning and state monopolies disappeared. As a result, some countries experienced a surge of imported products that competed with their domestic farm products. Many CEE countries responded by adopting import tariffs or increasing existing tariffs (Hungary, Romania, and Bulgaria), while some imposed surcharges on agricultural imports (Hungary and Slovakia). Restrictions on trade may also have been applied to impose price ceilings for key commodities or alleviate shortages of basic commodities through the use of export bans, restrictions, taxes, and licenses. More recently, some countries have increased protection from imports with the implementation of commitments made during the Uruguay Round.

The CEE countries represent a potentially large export market, with good growth potential, albeit with uncertain prospects for U.S. trade as EU competition in the region offers a major obstacle to increased exports. The EU is the most important trading partner of the CEEs, and the source of about half of all CEE agricultural imports. The EU has benefited from natural advantages conveyed by geographic proximity to the CEEs, lower transport costs, long-standing cultural ties, ease of market servicing, and possibility of frequent direct contact with customers. In addition to these advantages, the EU has been able to use export subsidies to ship product to the CEE market. The EU-CEE association agreements (see box on "EU Association Agreements") give the EU preferential access to the CEE market. Unfortunately, U.S. exports to the CEE countries presently represent only 5 to 10 percent of the market and are not diversified, consisting primarily of wheat, feed grains, and poultry meat. Despite a doubling of U.S. high-value products exports to the CEEs, the United States faces stiff competition from the EU in meeting fast-growing CEE demand for HVP imports.

Uruguay Round Commitments May Reduce Market Access

In their Uruguay Round Agreements, several CEE countries adopted high levels (i.e., higher than the levels in force at the time) of their most-favored nation (MFN) tariffs in their new tariff schedules. Poland's bound tariffs were aligned with EU tariff levels in anticipation of Poland's eventual membership in the EU. Hungary raised its bound tariffs on many products including grains, livestock products, horticultural products, oilseeds, and some consumer-ready foods. The tariff levels currently in effect for most products are lower than the bound rates, but nonetheless the authority exists to raise tariffs to the higher bound levels without fear of WTO reprisals. Were these countries to apply the higher rates, current market access opportunities would be reduced to what is available under tariff-rate quotas.

Under their Uruguay Round commitments, many of the CEE countries opened tariff-rate quotas for a number of products. Tariff-rate quotas permit a specific level of imports to enter a country at a reduced tariff rate. Imports in excess of the quota are subject to the higher MFN tariff rates. Poland and Hungary established quotas for many products, including some of importance to the United States, such as Hungary's quotas for rice, planting seeds, snack foods, and peanuts. The Czech Republic and Slovakia opened tariff rate quotas on live animals and meat products, selected dairy products, some fruits and vegetables, and some processed foods. New tariff-rate quotas may not always succeed in increasing imports since some imports may already be in excess of the quota or the in-quota tariff rate may already be the applied rate or too high for trade to occur.

Sanitary and Phytosanitary Agreement Seeks To Limit Trade Barriers

The Sanitary and Phytosanitary (SPS) Agreement of the Uruguay Round was established to combat the increasing number of technical barriers to trade posed by sanitary and phytosanitary restrictions, many of which are not scientifically based. The agreement established basic rights and obligations for food safety and animal and plant health measures that affect trade. Under the agreement, countries will be permitted to impose only those requirements needed to protect health and safety and which are based on scientific principles. The agreement permits different processes to be mutually recognized, provided they produce the same results (equivalence). The United States and the EU are establishing equivalence in animal and public health standards for many livestock products. In theory, under the SPS Agreement trade should not be impeded by SPS measures if some sort of equivalency in protection procedures and health standards has been reached. However, in practice, this is sometimes not the case, as the United States-EU beef hormone dispute illustrates.

When the Central & Eastern European countries join the EU, they will adopt EU veterinary, sanitary, and phytosanitary standards. Whatever restrictions on trade exist between the EU-15 and its trading partners will then also apply to the new member countries. This could present problems for U.S. access to the CEE-10 countries, a market of some 100 million consumers. After enlargement, long-standing U.S.-EU disputes over pet food, rendered products, bST (bovine somatotropin, a growth hormone), and more recently, and genetically modified organisms will have a greater impact as they will affect not only the current EU-15 countries, but nearly all of Europe. In fiscal 1995, the United States exported 580,000 tons of beef to Central & Eastern Europe. The implications of enlargement for this trade depend on the outcome of a WTO dispute settlement panel. A decision on whether the EU's ban on hormone-treated beef is a legitimate SPS measure is expected in 1997. If the panel decides in favor of the EU's continued application of the ban, the United States will ultimately be unable to ship beef produced from cows treated with hormones to 21 countries. If the panel decides that the measure is not legitimate, the EU may lift the hormone ban. But if the EU chooses to retain the measure, it will be required to compensate its trading partners for the value of the lost trade.

State Trading Enterprises Cloud Near-Term Trade Prospects

The preponderance of state traders in agricultural markets is becoming an increasing concern of the United States. State Trading Enterprises (STE's) are governmental or nongovernmental enterprises or marketing boards that have been granted exclusive or special rights or privileges to trade. They raise WTO-related concerns because of their ability to influence through purchase or sales the level or direction of imports or exports. STE's may be a means of circumventing WTO agricultural disciplines and inhibiting trade. STE's involved in exporting can take pricing risks, using government facilities, such as underwriting of payments, transports, and interest rate subsidies, that a commercial trader cannot. STE's have greater flexibility in discretionary pricing through the use of price pooling, and can use domestic monopoly power to cross-subsidize between domestic and foreign markets. As importers, STE's can make market access commitments meaningless. Several countries are attempting to introduce new state traders to administer their Uruguay Round tariff-rate quotas.

While Hungary and Romania claim to have no STE's, Poland, the Czech Republic, and Slovakia have notified the WTO of the existence of their STE's: the State Fund for Market Regulation in the Czech Republic, the State Fund for Market Regulation in Slovakia, and the Agency for Agricultural Markets (ARR) in Poland. In all three countries, the STE's have considerable market power over the commodities regulated and hence, a strong effect on domestic and trade prices. For example, the ARR in Poland possesses a significant share of the domestic market power for grains through its direct intervention purchasing, by the credit it provides to state milling companies, and through the partial advance payments it makes to farmers. The lack of transparency of STE activities makes it difficult to determine to what extent the principles of the GATT may be violated.

When the countries of Central & Eastern Europe join the EU, they will adopt the policies and mechanisms of the Common Agricultural Policy, which means, for example, creating intervention agencies for the purchase and sale of

intervention stocks for the EU Commission. As part of this process, their STEs will likely follow the route of their Western European predecessors, ONIC and SENPA. ONIC and SENPA, the French and Spanish grains organizations active in marketing, are former marketing boards that predated formation of, or accession to, the EU. Formerly monopoly buyers, these organizations are now intervention agencies, responsible for buying agricultural products into intervention and the selling of stocks for the EU Commission. They operate with the authorization of the Commission. While these organizations are making purchases and sales, not all sales are carried out by the intervention agencies. Private traders are responsible for all imports and exports, while private enterprises and producer cooperatives also conduct sales and purchases on the domestic market.

If the CEE STE's go the way of their predecessors, much of the power currently in the hands of STE's will be ceded to the European Commission, while other powers must be relinquished to private market mechanisms. Until that time, the operations of STE's may make it difficult for some products to penetrate the CEE market.

Enlargement Makes Trade Outlook Uncertain

Accession to the EU is expected to alter the outlook for U.S. trade with the CEE countries. As the CEEs come under the EU's import regime, the principle of community preference, whereby the EU (like all customs unions) discriminates against third-country imports in favor of products from other member countries, will result in higher protection against goods from the United States and other non-EU countries.

Many CEE countries are implementing agricultural policies similar to the EU's Common Agricultural Policy in anticipation of EU membership. Under CAP-like policies, surpluses of many agricultural products, particularly primary products, can be expected to develop in the region. If enlargement takes place under the current CAP, the production of surpluses in the region will likely be exacerbated by the CAP's strong incentives to produce. Such a development would be harmful to U.S. agricultural exports to the CEE, and could also mean increased competition for U.S. exports in third-country markets.

While some look to enlargement as the catalyst for further reform of the CAP, it is possible that the EU could become more protectionist with enlargement. Enlargement will bring into the EU countries that are producing commodities already in surplus in the EU-15. Most CEE countries have the potential to significantly expand production, which could intensify pressure for increased protectionism in an enlarged EU. Even if the CEEs come into the EU without benefit of the high price and income support embodied in the current CAP, they will benefit from EU structural programs aimed at improving production and marketing infrastructure, which could boost production capacity. Further CAP reform may not provide relief from protectionist pressure if, like the last round, it results in no liberalization of market access. The 1992/93 reforms were targeted at bringing internal supply/demand into better balance by lowering support prices and controlling supply of products in surplus. It is unlikely, barring another round of significant tariff reductions under the WTO, that enlargement will lead to expanded access for third countries, even if comprehensive reform of CAP is undertaken.

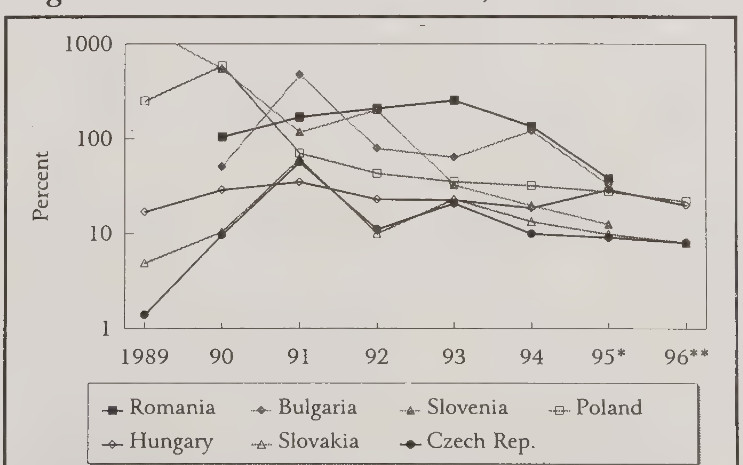
There are, however, some positive things to say about the prospects for U.S. agricultural exports to the CEEs after accession. Income growth resulting from EU membership should raise the overall level of demand, and U.S. exports could rise as total exports to the region expand, even as the U.S. share shrinks. U.S. exports may also benefit from increased demand from an expanding livestock sector for certain items like oilseeds, oilseed products, and some feeds that already enjoy duty-free access to the EU market, as well as inputs to an expanding and modernizing farm sector.

Climate for Investment Mixed

As increased protection and competition from the EU in the market for agricultural goods render trade prospects uncertain, U.S. businesses may find that investing in this region will allow them to take advantage of expanding demand. The climate for investment by agricultural industry differs by country based on the state of economic development, farm structure characteristics, the adequacy of infrastructure, the openness of the economy, and enforcement of intellectual and other property laws. Economic developments in the general economy are generally favorable for investment. As economic recovery begins and inflation declines, CEE countries will be better able to obtain credit at more reasonable rates of interest, provided financing is available (figure 9).

The region offers many advantages for investors: favorable and diverse agronomic characteristics capable of producing a wide range of crops and livestock, governments that recognize the need for foreign investment as a source of capital and expertise, and an educated, low-cost labor force. The region's large population and growing income offers a potentially larger market for many diverse products.

Figure 9. Inflation in the CEEs, 1989-96



*1995 provisional, **1996 forecast.
Note: Slovenia's 1989 inflation rate was 1306%.
Source: OECD.

The farm and food processing sector should be poised for expansion, having experienced a large decline in demand, and a resultant contraction in agricultural output, in the transition to a market-oriented economy. Agricultural GDP has begun to recover in most countries, which should provide opportunities for investors particularly in upstream sectors such as fertilizers and agricultural machinery, and in downstream sectors such as food processing and distribution (figure 10).

Opening of markets through bilateral agreements (primarily with the EU) should provide opportunities for increased trade in the region that, although not necessarily favorable for U.S. exports, may be a boon for those seeking to invest in and export from the region. The CEE region is in competition for investment dollars with other high-growth regions (notably Asia and South America), but the CEEs' advantage lies in their human capital and their position at a crossroads between western and eastern markets and on the doorstep of the large, affluent western European market.

Obstacles to Investment Remain

Although the basic ingredients are in place for increased investment, serious difficulties remain. The CEE countries' transition to market economies is not yet complete. In particular, agriculture will take a long time to recover from years of distortion under central planning. There is still some political and economic instability in region. In some countries, there is political pressure to slow the pace of economic reform, and recent elections have produced a resurgence of former communist and more socialist governments. Some countries have experienced increased pressure for protectionism from those who have found the transition to a market-oriented system difficult or painful. Risk is an important consideration for potential investors in the region.

Despite strong growth, per capita incomes are still low relative to developed market economies, and unemployment is high. Markets for land are not well-developed, increasing risks and transactions costs. Privatization is not complete, especially in the agroindustrial sector, where ownership issues create uncertainty for investors. In this sector in particular, many of the remaining non-privatized enterprises are among the largest (figure 11).

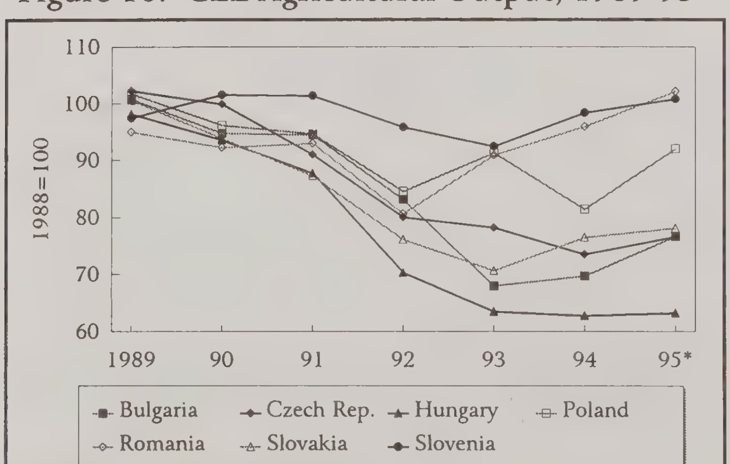
Infrastructure is frequently inadequate, particularly in rural areas, where poor communications facilities, roads, and sanitation increase the costs of doing business for potential investors. A major bottleneck is the lagging reform of the processing and distribution sectors, which are still state-owned in some countries. Some countries' legal structure may not yet be developed for private business operations, and laws regarding property rights and intellectual property protection are often inadequate. Product quality, particularly of livestock products, can be a problem for processors accustomed to western European or U.S. standards. Some CEE countries often impose export bans and restrict export licensing, which hurts trade and hinders investment by creating uncertainty.

Despite a sometimes difficult environment, there are opportunities for profit. Opportunities for investors in agriculture are linked to the increased mechanization of the farm sector, high-tech inputs, and land consolidation. Many observers believe that despite an uncertain environment, it is important for investors to move quickly to capitalize on existing opportunities, to establish a commercial presence early and begin to develop consumer loyalty because competition in the region will only increase. In light of impending EU membership, it is particularly important for non-EU investors to become established before community preference raises barriers to non-EU products and firms. Growing income offers opportunities in high-value and processed products, and in oilseeds and other inputs such as for the expanding livestock sector.

CEE Membership in EU Raises Stakes, Costs for Investors

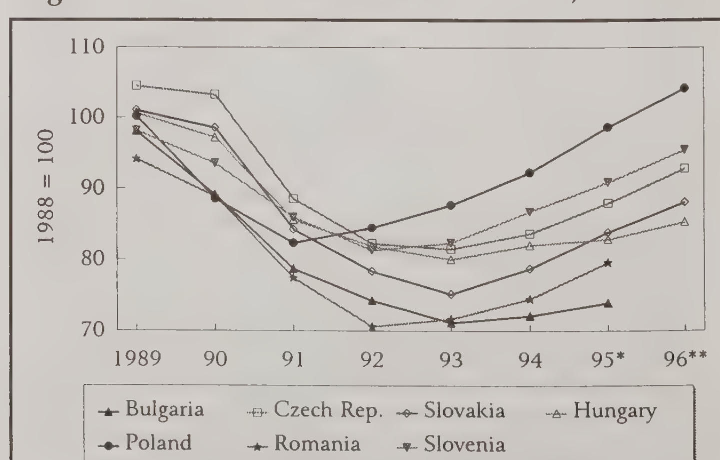
CEE membership in the EU could be a favorable development for investors in the agricultural sector seeking to establish a presence in Europe. Enlargement will expand the market size available to the investor, providing preferential access to the 370 million high-income consumers of the EU-15, and an additional 100 million

Figure 10. CEE Agricultural Output, 1989-95



*1995 provisional. Source: OECD.

Figure 11. CEE Gross Domestic Product, 1989-96



*1995 provisional, **1996 forecast. Source: OECD.

scheduled for EU membership. Output of many agricultural products in the CEEs is expected to expand under the CAP, but the extent will depend on how much price and income support is offered to CEE producers. Investors with a stake in agricultural industries could be well-positioned to benefit from this expansion.

Harmonization of CEE product quality and standards to EU levels will likely be favorable for trade, because it will improve export prospects. EU assistance to the CEEs through structural funds will also address some of the obstacles to investment currently posed by an outdated agricultural infrastructure. And EU membership may address some of the problems attendant to economic and political instability and lack of transparent economic and legal systems, reducing risk to investors.

Such benefits, if they occur, would not be without costs. The agricultural sectors of the CEEs are rife with distortions resulting from many years of a command economy structure. The EU's CAP, even if "reformed," may simply replace one set of market distortions with another. Under the current CAP, large differences exist between most EU prices, those prevailing on the world market, and prices in CEE countries. Higher agricultural prices following CEE membership could reduce the competitiveness on world markets of businesses based in CEE countries.

Despite short-term improvement in the trade outlook, EU membership may limit opportunities for U.S. agricultural exports to the CEE countries. With EU membership, incentives to increase production raise the possibility for the CEEs to become competitive with the United States in some products in the long term. The best opportunities in the CEE region lie in exports of HVP's, targeted bulk commodities, and investment opportunities in certain sectors.

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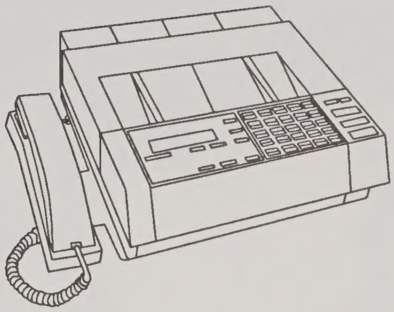

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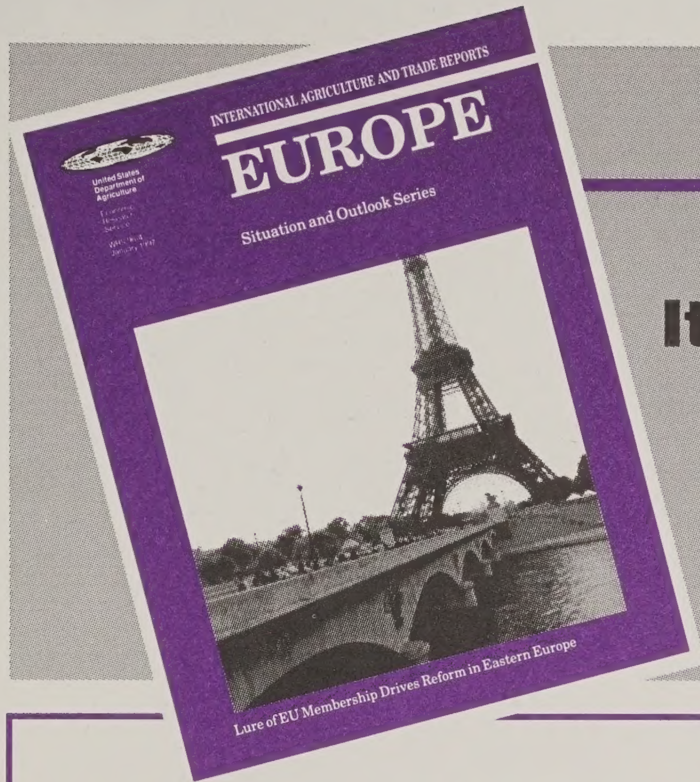

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